TAX INCENTIVES AND SMALL BUSINESS EXPORTS

HEARING

BEFORE THE

SUBCOMMITTEE ON TAX, ACCESS TO EQUITY
CAPITAL AND BUSINESS OPPORTUNITIES

OF THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

NINETY-SEVENTH CONGRESS

SECOND SESSION

WASHINGTON, D.C., SEPTEMBER 16, 1982

Printed for the use of the Committee on Small Business

U.S. GOVERNMENT PRINTING OFFICE
11-355 O WASHINGTON : 1982

H721-4

COMMITTEE ON SMALL BUSINESS

PARREN J. MITCHELL, Maryland, *Chairman*

NEAL SMITH, Iowa
JOSEPH P. ADDABBO, New York
HENRY B. GONZALEZ, Texas
JOHN J. LaFALCE, New York
BERKLEY BEDELL, Iowa
HENRY J. NOWAK, New York
THOMAS A. LUKEN, Ohio
ANDY IRELAND, Florida
IKE SKELTON, Missouri
BILLY LEE EVANS, Georgia
CHARLES W. STENHOLM, Texas
ROMANO L. MAZZOLI, Kentucky
NICHOLAS MAVROULES, Massachusetts
CHARLES HATCHER, Georgia
RON WYDEN, Oregon
DENNIS E. ECKART, Ohio
BYRON L. DORGAN, North Dakota
GUS SAVAGE, Illinois
BUDDY ROEMER, Louisiana
JOHN G. FARY, Illinois
—— ——
—— ——

JOSEPH M. McDADE, Pennsylvania
SILVIO O. CONTE, Massachusetts
J. WILLIAM STANTON, Ohio
WILLIAM S. BROOMFIELD, Michigan
DAN MARRIOTT, Utah
LYLE WILLIAMS, Ohio
OLYMPIA J. SNOWE, Maine
DANIEL B. CRANE, Illinois
JOHN HILER, Indiana
DAVID MICHAEL STATON, West Virginia
VIN WEBER, Minnesota
HAL DAUB, Nebraska
CHRISTOPHER H. SMITH, New Jersey
ED WEBER, Ohio
DAVID DREIER, California
GUY V. MOLINARI, New York
MARK D. SILJANDER, Michigan

Major L. Clark III, *Staff Director*
Thomas G. Powers, *General Counsel*
Lois Liberty, *Publications Specialist*
Raymond S. Wittig, *Minority Counsel*

Subcommittee on Tax, Access to Equity Capital and Business Opportunities

HENRY J. NOWAK, New York, *Chairman*

BILLY LEE EVANS, Georgia
BYRON L. DORGAN, North Dakota
GUS SAVAGE, Illinois
BUDDY ROEMER, Louisiana
JOHN G. FARY, Illinois

DAN MARRIOTT, Utah
OLYMPIA J. SNOWE, Maine
DANIEL B. CRANE, Illinois
VIN WEBER, Minnesota

Benson S. Goldstein, *Subcommittee Counsel*
John T. Caulfield, *Subcommittee Associate Counsel*
Richard L. Centner, *Minority Subcommittee Professional Staff Member*

CONTENTS

Page

Hearing held on September 16, 1982 1

Opening statements of:

Marriott, Hon. Dan, a Representative in Congress from the State of Utah. 8

Nowak, Hon. Henry J., chairman, Subcommittee on Tax, Access to Equity Capital and Business Opportunities 1

Panel consisting of:

McDonough, Leo R.; John C. Rennie; and Alexander Zakupowsky, Jr. 221

Testimony of:

Frenzel, Hon. Bill, a Representative in Congress from the State of Minnesota 3

Jackson, James K., counsel, Special Committee for U.S. Exports 10

Korbel, John, senior manager, Price Waterhouse; accompanied by Bernard M. Shapiro, national director of tax policy, and Abram E. Hoffman, senior manager, economic and regulatory services 76

March, Frank A., president, Seaward International, Inc., Falls Church, Va., on behalf of National Ocean Industries Association; accompanied by Leonard Kriss, attorney 67

McDonough, Leo R., executive vice president, Smaller Manufacturers Council, Pittsburgh, Pa. 221

Rees, Thomas M., attorney, Washington, D.C., and former chairman, Subcommittee on International Trade, Investment and Monetary Policy, Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives 162

Rennie, John C., president, Pacer Systems, Inc., Burlington, Maine, and vice president, Smaller Business Association of New England (SBANE).. 260

Zakupowsky, Alexander, Jr., partner, Deloitte, Haskins & Sells 265

Additional material supplied for the hearing record:

Boren, Hon. David L., a Senator in Congress from the State of Oklahoma: Prepared statement 2

Bruce, Charles M., attorney, Cole & Corette:
  "Foreign Tax Practices Affecting Exports," study, July 1982 273
  Prepared statement 272

Frenzel, Hon. Bill, a Representative in Congress from the State of Minnesota: Prepared statement 3

Jackson, James K., counsel, Special Committee for U.S. Exports:
  Prepared statement 13
  Responses to March 17, 1982 SCUSE letter 17

Korbel, John, senior manager, Price Waterhouse: Report, "Economic Impacts of the Domestic International Sales Corporation (DISC) Tax Provisions," Apr. 15, 1982 80

Lupo, Gerald J., president, G. J. Lupo Co., Inc., Salt Lake City, Utah: Prepared statement 328

March, Frank A., president, Seaward International, Inc., Falls Church, Va.: Prepared statement 69

McDonough, Leo R., executive vice president, Smaller Manufacturers Council, Pittsburgh, Pa.:
  "Accountants Say DISC Is a Moneymaker," synopsis of Price Waterhouse study 223
  "Analysis of the 1981 Treasury Report on DISC," by William H. Green, with attachments 240
  "Alternatives for Domestic International Sales Corps. (DICS's)," memo and attachments 225

Additional material supplied for the hearing record—Continued
  - McDonough, Leo R., executive vice president, Smaller Manufacturers Council, Pittsburgh, Pa.—Continued
    - Fairbanks, Frank, president, Smaller Manufacturers Council, and president, Horix Manufacturing Co.: Prepared statement .... Page 238
    - "U.S. Is Drafting Plan to Give Exporters Bigger Tax Cuts, Meet GATT Objections," Wall St. Journal, July 15, 1981 239
    - White House Conference on Small Business, "Trade and Domestic International Sales Corporation," final analysis 222
  - Rees, Thomas M., attorney, Washington, D.C., and former chairman, Subcommittee on International Trade, Investment and Monetary Policy, Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives.
    - Report, "White House Conference on Small Business" 171
    - Suggested amendments to IRC DISC provisions 215
  - Rennie, John C., president, Pacer Systems, Inc., Burlington, Maine, and vice president, Smaller Business Association of New England (SBANE): Prepared statement 263
  - Zakupowsky, Alexander, Jr., partner, Deloitte, Haskins & Sells: Prepared statement 268

TAX INCENTIVES AND SMALL BUSINESS EXPORTS

THURSDAY, SEPTEMBER 16, 1982

House of Representatives,
Subcommittee on Tax, Access to Equity
Capital and Business Opportunities,
Committee on Small Business,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:50 a.m., in room 2359-A, Rayburn House Office Building, Hon. Henry J. Nowak (chairman of the subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN NOWAK

Mr. Nowak. The subcommittee will come to order.

We have a rather tight schedule this morning and we would like to start with our testimony as soon as possible.

Today we are holding an investigatory hearing on tax incentives and small business exports. Witnesses will present testimony regarding the utilization by small business of the so-called Domestic International Sales Corporation tax incentive. The hearing will also explore the underlying rationale of providing tax incentives for exports.

For the purposes of the Internal Revenue Code, a DISC is a domestic corporation which generally derives 95 percent of its gross receipts from exports and related activities, and has 95 percent of its assets involved in exporting. Those DISC's increase export sales over a base period amount are generally permitted to defer the tax on 50 percent of export income. With respect to the economic impact of these provisions, there were 7,208 active DISC's in 1979 with total export gross receipts of $99.6 billion.

I am particularly encouraged by the potential impact that increased exporting could have on the growth of our work force. This is significant in light of the fact that small business creates approximately 80 percent of all the new net jobs in the United States.

Further, by fostering the exports of small business, the Nation will be utilizing an important avenue for broadening its own economic base. It would provide our cities with a hedge against general downturns in the economy, as well as a vehicle for increasing business opportunities for other domestic industries and suppliers.

The Reagan administration and Congress should closely examine and analyze the current market forces existing in international trade. We must stand ready to provide American firms, and small businesses in particular, with the proper tools to compete in world markets.

With respect to the simmering debate over the modification or replacement of DISC, I would like to close with two points. First, we must work toward the objective of providing incentives that truly increase our level of exports abroad and which create jobs at home. Second, we must recognize that small- and medium-sized firms have a critical stake in this debate.

Without objection, we will place in the record the statement of the distinguished Senator David L. Boren.

[Senator Boren's prepared statement follows:]

PREPARED STATEMENT OF HON. DAVID L. BOREN, A SENATOR IN CONGRESS FROM THE STATE OF OKLAHOMA

I want to thank the chairman for having the foresight to organize these hearings on a topic which must be dealt with in the near future. The Domestic International Sales Corporation (DISC) is the most significant incentive available to exporters in this country. In 1979 there were 7,208 active DISC's and the provision was directly associated with over 65 percent of U.S. manufactured exports. The tax deferral which DISC provides is an important means of preserving cash flow for many small businesses, as well as large multinationals, that are involved in exporting.

Many smaller companies have been discouraged from using DISC for a variety of reasons. I feel strongly that smaller business should be included in, not excluded from, the field of international trade. Small business accounts for over half of our domestic production yet, according to the Commerce Department, a mere 1 percent of U.S. companies account for roughly 80 percent of U.S. exports. Regardless of these concerns, the very existence of DISC is now in jeopardy.

The dispute within the Council of the General Agreement on Tariffs and Trade (GATT) concerning DISC has made it necessary for the U.S. to create an alternative to DISC. The alternative must preserve the benefits of DISC, resolve the GATT dispute issues, and make the provision more accessible to smaller exporters.

In July, I introduced the Export Sales Corporation Act, S. 2708. This bill is designed to accomplish the above-mentioned goals. The export sales corporation would operate as a subsidiary through which the U.S. exporter would make export sales, or perform export services. Its scope would be basically the same as the present DISC. The difference, designed to answer the challenge to the legality of DISC under international law, is that ESC's would be set up, not in the United States, but in a U.S. territory (excluding Puerto Rico) or in a foreign country that imposes taxes. Thus, ESC's would be similar to companies utilized by the Japanese, Dutch, French, and British exporters. It would provide a means of avoiding double taxation of foreign source income that is clearly legal under international law. I do not believe that DISC is a violation of the GATT and the legislation I have proposed would not repeal it. The ESC system, however, would be so attractive to U.S. exporters as to render questions about the legality of DISC moot.

This legislation is designed to be revenue neutral, in that the revenue cost of export sales corporations will be equal to recent revenue cost estimates for DISC.

Provisions creating new incentives for smaller exporters are also included in my bill. Under this legislation, the Treasury Department is authorized to promulgate regulations to permit unrelated shareholders to participate in exporting through an ESC on a patronage basis. That is, the benefits would accrue to shareholders according to the volume of exports each had run through the ESC. Additionally, ESC's with small exporters as members will be allowed a $5,000 tax credit to help defray the added administrative costs.

I recognize that the biggest problem many small businesses have in entering the export market is lack of adequate information. I do not want to inhibit smaller companies from fully utilizing ESC's where they can. My bill, therefore, directs the Treasury Department to publish a revised Handbook for Exporters, one that highlights the uses of the ESC for smaller companies.

We are presently faced with chronic trade deficits and cannot afford to ignore the creative potential of the small business community. Smaller businesses should have access to the most important export incentive the United States has. The U.S. needs the contributions of small exporters and I believe that the Export Sales Corporation Act would be a significant step in the right direction.

Mr. Nowak. Our first witness this morning will be our colleague, Bill Frenzel, who sits on the Ways and Means Committee's Subcommittee on Trade. He certainly is an expert in this area, and has introduced legislation concerning this DISC modification problem, as well as being active in all international trade issues. He is also the congressional representative to the Council of the General Agreement on Tariffs and Trade, or GATT, as it is popularly known.

If Bill Frenzel from Minnesota would come forward, we would be happy to hear your testimony.

TESTIMONY OF HON. BILL FRENZEL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MINNESOTA

Mr. Frenzel. Mr. Chairman, I am accompanied by a member of my staff, David Rosenauer, who is here to hold my hand.

I have a prepared statement which I will submit to the committee and ask that it be accepted into the record, and would prefer to proceed extemporaneously.

Mr. Nowak. Without objection, it is so ordered.

[Mr. Frenzel's prepared statement follows:]

Prepared Statement of Hon. Bill Frenzel, a Representative in Congress From the State of Minnesota

Mr. Chairman, thank you for providing me with the opportunity to appear before this distinguished subcommittee to address the issue of DISC and other export tax incentives. The need for additional incentives for small businesses to export is great, and I applaud this committee for taking the necessary first step towards developing what I hope will be a meaningful tax policy encouraging exports.

As you well know, the cornerstone of our current tax policy concerning exports is the DISC. Unfortunately, DISC has not fulfilled the expectations of its creators, and has been extremely controversial both in the Congress and in the international community. In the Congress, DISC benefits have been increased or scaled back depending on the general fiscal mood of the Congress, without any real emphasis on the reason for the DISC—the need to increase exports. As recently as this year's Tax Equity and Fiscal Responsibility Act, DISC was singled out as an undesirable "tax preference," and the benefits of the DISC were substantially reduced.

DISC has also run into some serious obstacles among our major trading partners. Since its inception, and with increasing regularity, many of our trading partners have filed complaints that DISC does not conform to the General Agreement on Tariffs and Trade (GATT), an agreement to which the United States is a signatory. The complaining countries are not objecting to the meager amount of DISC benefit most exporters receive. To do so would be to raise serious questions as to the legality of their own, far more generous, export programs. Instead, they are complaining about the form of the DISC.

Although there have been periodic ceasefires in the war over the DISC, the issue of GATT conformity appears to be a battle the United States is likely to lose. In my judgment, the only way we can resolve the issue will be to develop a new tax program—the effect of which is to encourage exports.

In order to stimulate discussion as to possible alternatives to the DISC, last year I introduced H.R. 5179, a bill that replaces the DISC with International Sales Corporations (ISC's). Since the introduction of the bill, I have received a considerable amount of input on how to improve the original proposal. Among the comments I received were several suggestions as to how the bill could provide additional incentives for small exporters.

Generally, my proposal, which will be redrafted within the next several weeks, allows U.S. exporters to use a foreign subsidiary (an ISC) for their exporting and receive the profits from the subsidiary tax-free. The bill requires the ISC to be incorporated in a foreign country where it will be subject to some tax, and it also requires the ISC offices to be outside the United States. However, small exporters, those with exports of less than $10 million annually, will be allowed to maintain their ISC offices in the U.S., although they will still be required to be a foreign corporation.

In a further attempt to facilitate the formation of ISC's by small businesses, the bill will allow each ISC to have up to 35 shareholders. A small exporter could join an ISC with 34 other companies that had less than $10 million in exports each, and substantially reduce its costs in establishing the ISC.

Using an ISC, an exporting U.S. company will be able to sell its products to the ISC using "arm's-length" pricing rules similar to those found in the DISC. The ISC would then turn around and sell the product in foreign markets. The ISC would be required to pass-through substantially all of its profits back to the ISC shareholders in the form of a dividend. The shareholders receiving the dividend (the exporters using the ISC) would then receive a 100 percent dividends received deduction for the dividends from the ISC. In order to keep the revenue figures in line with the current budgetary targets, the 100 percent dividends received deduction will be phased in over several years. However, the initial benefit received under the ISC will still be substantially greater than those benefits currently available under the DISC.

My bill should not be looked at as a final solution to our export problems. Rather, it should be looked at as one possible alternative solution to the problems facing the DISC, both in providing a meaningful export incentive, and in meeting the objections of the GATT. Although the latest version of my bill reflects many of the comments I have received over the past 10 months, I am still open to suggestions for additional improvements in the bill.

Mr. Chairman, again I'd like to thank you and the rest of this distinguished committee for providing me with the opportunity to appear on this important issue.

Mr. **Frenzel**. Mr. Chairman, I am pleased that you are holding these hearings and grateful to be included in them. I think it is terribly important to provide additional incentives for small businesses to do more exporting and I hope what this committee is doing will lead toward that end. We have in this country only one very small, very feeble incentive to export, which we call the domestic international sales corporation.

It has not done, I think, all that we would have expected of it. As the committee is aware, most countries of the world have slightly different tax systems than we do. They usually remit taxes at the border in a general way, forgiving VIP, for instance, on all shipments moving outside of their country, and they are able to offer incentives for exports, in ways that we cannot because of our reliance on the income tax.

We invented the DISC a dozen years ago to provide some incentive. Unfortunately, most analyses have shown that it is not a very powerful incentive, it is better than nothing, of course, and we want to protect it until we can replace it with something better.

Small companies have found the DISC difficult and perhaps cumbersome. On the other hand, over the years, a number of small companies have been able to get into DISC's. Lawyers have become familiar with setting them up and I think those companies that are using them are profiting from them and are doing exporting that they would not be doing otherwise. However, there has always been objection to DISC in this country, both from tax reformers who see it as some sort of loophole and from our trading partners who see it as being contrary to the rules of GATT.

In fact, even those people who claim they want to increase exports have been pretty tough on the DISC. The Carter administration, in my judgment, tried to bargain it away unilaterally. This administration has singled out the DISC as a tax preference and in the Tax Act just passed a couple of weeks ago, DISC became an item of preference income and therefore subject to the minimum tax.

In the bill just passed by the Ways and Means Committee, which is likely to pass this year, subchapter S corporations newly formed will be prohibited from having DISC's. These are all barriers to trade, in my judgment, and unnecessary parts of our law.

Worst, however, Mr. Chairman, is that the DISC has been protested in the GATT as being not conforming to the GATT treaty. A panel has ruled against us and while we are defending DISC as vigorously as can be done in Geneva, it seems that ultimately we are going to lose that battle and somewhere or another, we are going to have to provide a different kind of tax law which will not discourage exports.

In order to get the ball rolling, I introduced this year, H.R. 5179. That replaces DISC's with what I call an ISC, an International Sales Corporation. What I really intended to do was to give the United States a true territorial tax system, that is, one in which companies operating abroad pay the taxes that are due in the country where the deal is made and not pay U.S. taxes in addition on top of them.

Since I introduced the bill, I have had considerable comment on it, and I am now working on a redraft which I hope will be far better. One of the elements of my bill is to make ISC's more readily available to small exporters, particularly those which are likely to have exports of less than $10 million, and they, unlike companies which have larger exports, will be allowed to maintain their offices in the United States, although to fulfill the concept of my act and to be GATT-legal, I think they will still have to be required to foreign corporations.

I have also provided the ISC's could be jointly put together by small businesses and could have as many as 35 shareholders. That could be an amalgam of a number of small exporters. I hope that once we have this kind of a territorial tax system in place, then U.S. exporting companies will be able to operate on a truly competitive basis with companies which are headquartered in other countries around the world. At the moment, U.S. companies normally carry some kind of a double burden due to the nature of our income tax code.

My bill is not going to solve all the problems of getting small businesses to export more vigorously. This year we have done a little bit with the Trading Company Act. We hope that Congress will be able to finish up on that. It is not strong enough, but it is a good start. But I must concur with the chairman that all of these things in total have to be looked at and have to be pushed if we are going to get American companies to begin exporting. Our businesses, and particularly our small businesses, have been happy in our domestic market, but we are now getting to the point where we have to get into world markets and there is plenty of room for American small business, which is competitive, in those world markets.

So I would say, Mr. Chairman, that the DISC matter is up in the air because we, as a nation, are defending DISC under attack in the GATT. There have been a fair number of suggestions of alternatives of how we might change the DISC to make it GATT-legal and we are just going to have to watch how those developments move along and items like my bill or other suggestions may be a part of the final answers that we are bringing up.

Mr. Chairman, again I am grateful to you for having these hearings and delighted to have had an opportunity to take part in them.

Mr. **Nowak**. Thank you very much. We started to look at this when the announcement came out, suggestions from the administration that this whole program be shelved. We fear that we must do something if we are going to remain competitive with other nations and our trading partners.

I know in reading some of the background of the problems that arose at the GATT negotiations on this particular point, and although that has been postponed or set aside for the short time, it certainly may come up again when you look at the recent steel countervailing duties that have been filed and the allegations in some of those petitions everything from interest-free or below-market loan rates is listed, government guarantees for loans, cancellation of loan obligations, cash grants to provide additional capital, employment subsidies, subsidies to lower the cost of coal, to producer subsidies for export financing loans from the European investment bank in terms that are more favorable in the market, research and development subsidies, writing off interest charges, rollover of loans made possible by those individual Government actions, and all types of regional subsidies. I think you are absolutely right when you say we have to have something that corresponds or we are not going to be living in a real world. Looking toward this problem, although it may not be the ideal incentive for us, it is certainly one that I think is necessary or should be modified and perhaps made stronger if we are going to compete in the world market.

It is interesting to look at some of the statistics. Financing through the Export-Import Bank, I understand subsidizes 7 percent of our exports in the area of financing. The Japanese exports are financed something to the tune of 44 percent. We are looking at ways to do something more with our own businesses. One problem, as far as small business is concerned, is the issue of complexity of the existing law.

I think that is a very real issue and you look at the statistical information that has come forward and you see that almost 90 percent is used by corporations that are producing sales of $10 million or more and very little by the larger small business group. Hopefully, we can find a way to include an easier method of entry for the small business community.

Mr. **Frenzel**. I agree with you. I think that is an important point. It is fair to note, however, that a lot of those smaller companies are participating in DISC subcontractors of larger ones.

Mr. **Nowak**. Do you think it would be illegal for GATT purposes at this stage if we retained DISC for small businesses and mandated everybody else to use the territorial so-called system approach?

Mr. **Frenzel**. I do. To be in conformity with our treaties, we have to have a general law, we cannot have specific laws that provide specific substitutes. As long as DISC has been fairly difficult for those small companies anyway, we should devise a territorial system, I think, that would be easier for smaller companies to get into. Those who have DISC's are always nervous about giving them up because they do not know what is coming behind. Obviously, we cannot get rid of DISC because it is the only thing we have until we have a new system in place.

Mr. **Nowak**. Well, we certainly appreciate the input you have already made to this subcommittee and I know that we will need more information.

Mr. Centner would like to ask one fast question before we go any further.

Mr. **Centner**. Mr. Frenzel, my understanding of the objection of GATT to the DISC is that it is an illegal export subsidy.

In what way does your ISC get around that? I mean, how do you avoid them coming back with the same arguments?

Mr. **Frenzel**. Well, under my bill, the United States simply chooses not to tax certain foreign corporations which happen to be subsidiaries of the U.S. companies, and that is the gimmick.

Mr. **Centner**. The Key there is that they are incorporated in foreign countries?

Mr. **Frenzel**. All the DISC's are foreign corporations, which, even though for small businesses, may have domestic side issues.

Mr. **Centner**. But is that the sweetener, then, that they get some tax revenue out of your arrangement?

Mr. **Frenzel**. Well, that makes it legal, yes.

Mr. **Centner**. Thank you.

Mr. **Nowak**. Now there are other ways you may be not GATT-conforming. We have to write some very difficult and complex arm's-length agreement pricing and costing arrangements so that we do not get transfers between corporations that are contrary to the rules. Just to follow up on that, the so-called territorial system is used by France and Belgium and other European countries now, is that not right?

Mr. **Frenzel**. Almost every country in the world that does any trading except us does it. I think, Mr. Chairman, that we can say that while other countries sometimes seem to be trading unfairly, I think as a general rule, you can say that most of the U.S. wounds are self-inflicted. We simply do not take advantage of things we could do, because we do not want to do it.

Mr. **Nowak**. Hopefully we can work together. We have been active before and submitted substantial testimony on various things such as LIFO and the tax bill last year. We can pull together a broad consensus of support for an initiative that may modify this to make it GATT-legal. I think the whole purpose should be to try to expand this as a small business area, and get that moving forward as you have said, to provide a way for us to be competitive in the world market.

We look forward to working with you and your subcommittee members as this goes on over the next few months and certainly into next year. I think it is going to be a very interesting kind of initiative to put together because I think it is going to have substantial impacts as all kinds of statistics show that the imports or the exports mean much to our employment base and our whole economic structure. I believe we have not put enough emphasis on this, although, as you say, other people look at DISC as a tremendous loophole.

But we go through those arguments every year. I want to thank you for taking the time to appear. I know you have another meeting at 10 and we have a vote on the House floor at the present time.

So we will recess for 10 minutes.

Thank you.

Mr. **Frenzel**. Thank you very much, Mr. Chairman.

[A short recess was taken.]

Mr. **Nowak**. The subcommittee will come to order.

We are waiting Dan Marriott, who has been very active and interested in this subject, and Mr. Centner, who is his counsel, will read a statement on his behalf into the record.

Mr. Centner.

OPENING STATEMENT OF HON. DAN MARRIOTT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF UTAH

Mr. **Centner**. Thank you, Mr. Chairman.

First, I'd like to commend you for calling these hearings on what I believe is a most appropriate subject matter for study by this subcommittee.

The members of this subcommittee are well aware of the importance, a critical importance I might add, of the small business community to the economic health of this Nation.

What may not be as well known is the fact that Federal programs designed to encourage exports are currently aimed primarily at large, multinational corporations, who are already in the export market.

In fact, the top 250 exporting firms in the United States account for about 85 percent of all current exports. According to the Commerce Department, there are at least another 1,800 small- to medium-sized firms who could do well in the export market, but who are prevented from doing so by a number of factors. Among those factors are: One, researching foreign markets for a product; two, contacting foreign markets for the product; three, legal considerations, such as patents and tariffs; and four, financing an export business.

This is by no means an exhaustive list; and, I'm certain your witnesses will note other problems with which they've had to deal.

Most of the problems, however, stem from the fact that small businesses are less likely to have the staff and internal resources necessary to perform these tasks. It is significant that one area singled out for attention by witnesses before the Senate Select Committee on Small Business in 1980 is increased and improved financial assistance. Unfortunately, the solutions most often proposed amount to more of the old tactic of simply throwing Federal dollars at the problem. For example, Thomas Rees, a former Member of Congress and Chairman of the Export Task Force of the White House Conference on Small Business, suggested that:

> Eximbank or the SBA should consider providing preexport financing to small businesses who have "bona-fide" export contracts, or should consider guaranteeing commercial bank credit extensions for this purpose.

Mr. Chairman, I would rather see you continue to look for incentive mechanisms, that is, rather than Government grants, loans or guarantees, look for ways to provide the incentive needed for the private sector to find small potential exporting firms a good investment. This approach would require greater private sector participation, with the kind of financial safeguards more typical of private funds than of Government funds. Moreover, it would return substantial benefits without committing additional Federal resources we don't have.

I would also like to suggest some possible solutions based on written testimony from one of my constituents, Mr. Gerald J. Lupo. I would like to submit his statement for the record.

The bottom line of Mr. Lupo's experience is that no one in the Salt Lake office of the Small Business Administration could provide him with the information that he needed to know how in order to capitalize his deal—a more than $1.2 million deal with the Soviet Union. By the time the regional office and Los Angeles office got back to him, the offer was withdrawn.

If the SBA is nothing else, it ought to be a good resource for the small businessman; in a sense, it becomes the staff he can't afford.

The worst part is that the Salt Lake office merely told him, "I'm sorry, we don't have any programs that can help you." Period. Aside from the fact that such is not the case, they acted in a way I consider entirely contrary to their mission. Rather than say, in effect, "Sorry, that's not my department," they ought to be the experts in small business matters. If the person approached doesn't have the answers, he or she ought to know where to find those answers.

If the service isn't provided directly by the SBA, they ought to know what private or public sector resources do provide it.

The fact is, private and public export specialists offer a multitude of free services. SBA counselors ought to know about them.

Second, they should provide the information in a concise form. Small businesses are often overwhelmed by vast amounts of information provided in answer to a simple question.

Third, keep the process of counseling short, simple, and complete. Be able to assess the business potential in the export market, then give specific information regarding the best target markets.

Finally, at least one SBA counselor in every district office ought to be a virtual expert in export problems facing small business, and more importantly, in ways to solve those problems.

It is a tragedy that, despite its role in our economy, small business accounts for only about 10 percent of our total exports. In the case of Mr. Lupo's firm, the loss of the export contract meant that about 30 additional new jobs were not created. I submit that we can't afford to continue shooting ourselves in the foot that way.

I am confident that this subcommittee will be able to make recommendations dealing with export trade that will be of benefit to both the small business community and the Nation as a whole, both in SBA operations—which come under the direct jurisdiction of the full committee—and in the matter of financing.

Mr. Nowak. Thank you very much. Mr. Marriott is going to attempt to finish a markup in another committee and come to this meeting. We certainly will have the information presented available to him.

Let me call at this time from the Special Committee for U.S. Exports, and Mr. James K. Jackson, who is a partner in the law firm of Dawson, Riddell, Fox, Holroyd & Jackson. He will testify on their behalf.

Mr. Jackson is a tax attorney and has appeared as a guest lecturer and written numerous articles on taxation. So, Mr. Jackson, if you will come forward, we will have your testimony and we will have the testimony of the National Ocean Industries Association after that. Then we will ask you both questions, which will probably overlap.

TESTIMONY OF JAMES K. JACKSON, COUNSEL, SPECIAL COMMITTEE FOR U.S. EXPORTS

Mr. **Jackson**. OK, thank you, Mr. Chairman. I will summarize the written statement that I submitted for the record.

Mr. **Nowak**. Your complete statement of course, will be entered into the record.

Mr. **Jackson**. Thank you. I think initially some background on the way the tax law has evolved and DISC sort of sets the stage for where we are today. The DISC program was enacted in 1971 as an offset to foreign tax practices. Also, an offset to the practices that had been adopted in this country, subpart F which taxes foreign-source income of certain type, the 482 arm's-length pricing rules, which are very stringent rules, particularly for a small business to comply with in the international area, the source rules, under section 861, other rules, such as bribes and other policy-type changes that for various reasons we have enacted into our law and have various merits on their own, but also have put us in a competitive position not equal to other countries which have not adopted the similar types of laws, even though quite often our Treasury and Government would indicate that other countries would be following these taxes.

They have looked at the competitiveness and more or less applauded the unilateral approaches of the United States. Well, the DISC came in because we were having trouble with our balance of payments, we were having trouble in foreign competition, and we recognized the need for an incentive. I think, unfortunately, as Mr. Frenzel stated, the incentive has never been what was intended for comparativeness, initially it was supposed to be 100 percent deferral on that portion of exports that were allocated to the DISC. That was carved down in the initial legislation to 50 percent.

Later, in 1975, we carved it down by an incremental approach, meaning that only exports above a certain base period could be eligible for the DISC which again substantially reduced the DISC benefit and finally just last month, we included DISC as a preference and again reduced the benefit by 15 percent. I think in part, there is some dichotomy between trade and taxes. It is DISC, I think in its inception, which really should be viewed as a trade issue, an incentive, and a comparativeness with foreign trade, not strictly a tax subsidy.

Even though it is a tax benefit because of the nature of our tax system, the rationale is very different from the other incentives people generally talk about.

During this same period, the European Community, Canada, and other countries attacked it, as you have already heard; the panel reports came out; the MTM was enacted in the new Subsidies Code with assurances to U.S. business that the DISC had been grandfathered, which turned out not to be the case; and more recently confidential materials have been released indicating that there were agreements that DISC would be repealed during those negotiations.

This has led to the current situation where the panel reports have been accepted with the European territoriality system, in effect, OK'd, and DISC still left as not in compliance and the special trade representative is indicating not the best of climates for the next meeting in October in Geneva.

This brings me to what DISC is, and why is it justified. I think the justification is just that our "foreign trading partners, really foreign trading competitors, what does the United States do to be competitive in foreign markets and meet what they are doing?"

I guess one of the best defenses of DISC itself is the attacks by the foreign governments on it which have gone on for the full decade, plus DISC has been in operation and is continuing.

The SDR has defended DISC in the recent sessions on the basis that even though it is not the same as territoriality, it is for less of an incentive, so, therefore, it should be OK.

The U.S. Government recognizes that our incentive is not nearly as great as the Europeans. The most recent study, which I will not go into because I notice that Cole and Corette will be testifying later today, just bolstered all the studies of the past, many of which the Special Committee had worked on, of the foreign systems and the benefits provided there by the French, Germans, et cetera.

On the economics, I would agree that DISC has not done as much as it should, but it has worked surprisingly well considering the handicaps, the constant revisions in the tax in the United States, plus the foreign attacks. We do have approximately 14,000 DISC's, many of which are small business, even though the dollars are loaded toward the large business end because of the size of the exports of the large exporters, there are many, many small exporters with smaller dollars, so the number of companies is weighed toward small business, but the dollars toward large business. The Price Waterhouse study and the Treasury studies and other studies have shown the economic impacts of DISC, and I think they are very favorable.

Again, I will let the Price Waterhouse people, when they testify, provide more detail on those economics. I found just recently a very interesting study by The Conference Board indicating that during 1977 to 1980 in the manufacturing area, 79 percent of all new manufacturing jobs were export-related.

I think this shows the importance of exports to the manufacturing sector and the economy as a whole. I think one of the more significant things we found was when we asked a random selection of our membership to come in with letters explaining what DISC meant to them, and to try to get a handle on it, that we received numerous letters from small business which I have attached to the testimony, all of which are not household names, if you will, they are small- and medium-sized business. They are from all over the country, and it is very telling to have people like Ahern International Sales in New Canaan, Conn., saying we are a babe in the woods in international trade policy; Atlantic Wood saying that without DISC, many of our employees would have been laid off. You have the A. T. Cross Pen Co., saying that they have 300 directly related export jobs in the DISC program and so forth.

I think that is really better testimony in many ways because it is from the horse's mouth of small business that I think this committee is more concerned with, than broad studies and what have you, because that is the man who is dealing with it.

I should also point out, which I think Congressman Frenzel did, that as well as these companies who have been brought into the DISC program, and they were brought into it with great fanfare when it came in because it was pushed, the Treasury made speeches across the country, as did the Commerce Department, and people were greatly encouraged to come into it. Then the balloon burst.

I am very happy with the success we have had, but in addition to the small businesses that have participated, there are a number of large companies that have done studies on their small business program.

I cited in the testimony the Boeing Co., where they found in a 20-year period, they had $11 billion in contracts from small business. So those exports of the jetliners are very meaningful to small business.

We have found and we have testified many times, however, that for small business, the program could be made much more effective. You could reduce the incremental approach for small business, eliminate complexity, increase the percentage of deferral for small business, and eliminate reporting investment and other requirements that we do not feel are necessarily needed in the small business area.

With regard to the current proposals, I guess even though our druthers would be to keep the domestic DISC system, if we are going to be forced abroad, we have looked at the Frenzel-Boren bills. We also looked at Ambassador Macdonald's statement on a system based on foreign-source earnings.

There has been no real detail on Ambassador Macdonald's suggestion, so we have no real comments, although generally the feeling I have gotten from companies and members is that the complexity would probably be too great there, particularly for small business. The indications are that people would prefer the Frenzel-Boren type approach of having an offshore territoriality approach. We feel very strongly that it would be extremely helpful to have an exception for small business from any complex set of rules to the extent that could be developed and run through GATT. For example, in the MTM negotiations on the procurement codes, there is a small business exception and maybe there is some opportunity in working in Geneva to have a system that would have certain exceptions for small business in any major change. The main thing we are looking for is a U.S. policy for exports, a need that has been recognized by the other countries in the world for their exports, that provides some certainty and reliability and some rules that can be pushed by the Small Business Administration, the Commerce Department, and other people, to encourage people to come into a program and continue to utilize it.

Thank you very much.

[Mr. Jackson's prepared statement follows:]

PREPARED STATEMENT OF JAMES K. JACKSON, COUNSEL, SPECIAL COMMITTEE FOR U.S. EXPORTS

My name is James K. Jackson. I represent the Special Committee on U.S. Exports. The special committee is a participating group of more than 1,200 business concerns and 80 supporting business associations whose operations and concerns are directed to the export of U.S. products. The special committee's major concerns are with the effect of the U.S. tax system on exports by U.S. businesses and the ability of those businesses to compete in foreign trade in view of the many tax advantages and incentives and direct and indirect subsidies provided to foreign competitors by their governments.

GENERAL

The only U.S. incentive for exports of any significance is the Domestic International Sales Corporation ("DISC") provisions in the Internal Revenue Code. Recent discussion of the DISC provisions have centered around the 15 percent reduction in DISC benefits as a part of the reductions in corporate tax preferences contained in the Tax Equity and Fiscal Responsibility Act of 1982 and the increasing attacks on DISC by other nations in Geneva under the General Agreements on Tariff and Trade ("GATT").

The current change in the Tax Act and controversy in GATT is consistent with the history of DISC. The attacks by our trading competitors are not surprising, whereas, the attacks and cutbacks here at home are both surprising and difficult to understand.

To put DISC into historical perspective, DISC was enacted in 1971 following a period of years in which the tax treatment of U.S. exports was constantly made less advantageous than that of foreign competitors. During the 1960's, the subpart F provisions in the Internal Revenue Code were enacted providing for current U.S. taxation of foreign earnings in certain circumstances. In addition, the "arm's-length pricing" rules under section 482, and the source rules under section 861 of the Internal Revenue Code were changed, increasing U.S. taxes on exports and creating a widening competitive advantage abroad. The belief of U.S. tax officials that other nations would make similar changes in their systems was never realized, no doubt because they wished to enjoy their competitive advantage.

The widening gap in U.S. balance of payments lead to the original DISC proposal in 1969, which provided for 100 percent deferral of DISC income. The new system was intended to encourage exports and at least in part remove the competitive advantage of foreign tax systems. However, the initial DISC deferral was reduced to 50 percent when it was enacted in 1971. The DISC benefit was further reduced when a complicated incremental formula was enacted in 1975 along with the elimination of DISC treatment for certain natural resources, along with changes for exports of military hardware and other products. The 1982 Act enacted last month provides for a further 15 percent reduction in DISC benefits. Thus, the initial DISC proposal in 1969 has been reduced by over 75 percent of the intended benefit and DISC as enacted in 1971 has been reduced by more than 50 percent. In addition, legislation penalizing U.S. exporters for participating in a boycott or engaging in bribes and kickbacks was enacted during the 1970's, further limiting U.S. exports.

During this same period, our foreign competitors, lead by the European Economic Community (EEC), filed GATT complaints against DISC shortly after its enactment. The result was a GATT panel report that DISC, along with the tax practices of Belgium, the Netherlands and France (in other panel reports), was in violation of GATT. No action was taken on the panel reports due to the multilateral trade negotiations which lead to a new subsidies code enacted by Congress in the Trade Agreements Act of 1979.

Assurances were given by U.S. negotiators that there would be no required change in DISC under the new subsidies code, even though the deferral of tax was specifically listed as a subsidy. However, the Carter administration opposed DISC and a recently released confidential document states that Mr. Hufbauer, a U.S. Treasury official, on June 8, 1979, committed the U.S. to abolish DISC after the 1980 elections. This understanding was repudiated by Special Trade Representative Ruebin Askew, shortly after he took office.

However, the EEC and other nations continued their attacks on DISC. Last year the GATT Council concluded its deliberations on the four panel reports by adopting them with qualifications permitting countries not to tax economic activities outside their boundaries. The effect was to sanction the so-called "territoriality systems" used by the other nations. The U.S. took the position that DISC is not as beneficial to experts as the territoriality systems and, accordingly, is also permissible under the qualifying language.

The U.S. arguments have not been accepted in Geneva and the attacks on DISC have accelerated. U.S. negotiators have indicated that DISC will be very difficult to sustain and that the EEC has requested sanctions against DISC.

Thus, even though the DISC program has been substantially reduced by Congress, the pressure from other nations to repeal it has increased. This has resulted in various proposals to modify DISC to make it more in accordance with the systems of other nations which are not in violation of GATT.

JUSTIFICATION OF DISC

The obvious and probably best justification of DISC is the reaction to it by foreign competitors. Their constant attacks clearly indicate their view that DISC does alleviate the competitive advantage for their exports. Since the enactment of DISC, there has not been a meaningful reduction in foreign tax and nontax benefits to exporters. The most recent study, Foreign Tax Practices Affecting Exports by Cole & Corette, dated July 1982, concluded that "it is apparent that foreign exporters can benefit from tax planning to an even greater degree" than U.S. exporters. This is the argument that the U.S. Special Trade Representative has used in defense of DISC. The practices available to six major exporting countries were summarized in the study as follows:

1. Under the French territorial system, income of a foreign branch is generally not subject to French taxation. Alternatively, where foreign subsidiaries are used, a two-tiered dividend system permits the retention of untaxed foreign source profits while allowing the distribution of tax credit-bearing domestic profits to French shareholders.
2. There are a number of tax-free reserves that can be taken by a German parent with respect to its foreign subsidiary in harmony with a two-tiered dividend system similar to the French system, permitting the retention of untaxed foreign source profits while allowing the distribution of tax credit-bearing domestic profits to German shareholders.
3. A Japanese corporation, by making use of a combination of certain domestic reserves, tax treaty rules and foreign law can, by using a Singapore trading subsidiary, avoid any tax on both the subsidiary's income and on dividends paid to the parent, as well as obtain a domestic deduction for developing an overseas market.
4. In the Netherlands, the profits of foreign branches are generally exempt from Dutch taxes either by treaty or unilateral measures, while net losses of such branches often are deductible domestically. Where subsidiaries are used, income of a foreign subsidiary is not subject to Dutch tax nor are dividends received or capital gains arising from the foreign subsidiary generally subject to Dutch taxes. Also, offshore operations in the Netherlands Antilles, which are a part of the Kingdom of the Netherlands, are encouraged.
5. In Sweden, in addition to certain tax-free reserves for development of export markets and export credit allowances, there are a substantial number of favorable tax treaties under which Sweden has agreed to forego taxation of income of a branch of a Swedish corporation located in another state but will still allow the deduction domestically of the branch's losses.
6. A United Kingdom corporation can generally accumulate profits outside of the U.K. indefinitely. Using certain treaty countries, a U.K. corporation can receive domestic tax credits for taxes that it will not pay, because of a foreign tax holiday, under the "tax sparing" provision of the treaty.

The tax practices are coupled with other subsidies such as low interest rates and direct subsidies to make exports even more attractive to domestic business enterprises of other nations.

DISC has also been widely discussed from the standpoint of its economic impact. While there has been controversy, the facts clearly demonstrate the favorable incentive impact of DISC. Since its enactment, nominal exports have increased from $43 billion in 1971 to $220 billion in 1980, with the component of GNP increasing from 4.4 percent to 8.2 percent. During this period, the Treasury Reports on DISC illustrate the annual growth in the number of DISC's to 14,000 in 1981. The amount of export stimulation through 1979 according to Treasury Reports was $26.7 billion, growing from $1.9 billion in 1972 to $4.5 to $7 billion in 1979. In addition, various private sectors of Department of Commerce studies have indicated positive Federal revenues are generated by the DISC program due to the increased export activity.

The most recent study of the economic impact of DISC was conducted by Price Waterhouse, Economic Impacts of the Domestic International Sales Corporation (DISC) Tax Provisions (April 15, 1982). It, like previous studies, found a positive tax revenue feedback to the Treasury. It also, once more, refuted other arguments such as the floating exchange argument, DISC has no impact because it merely changes the exchange rate of the dollar. The surprising aspect of arguments such as the one based on floating exchange is that only the U.S. has ever considered it seriously in establishing export policy.

During a time of high unemployment, a compelling argument in support of stimulating exports is contained in The Conference Board's July 1982 report on U.S. Manufacturing Industry. It concluded "Export trade is becoming a major source of growth for the manufacturing industry, in terms of both employment and shipments. In 1980, there was some 4.8 million jobs related to export of manufactured goods—2.8 million in manufacturing plants and 1.9 million in nonmanufacturing activities. Between 1977 and 1980, 79 percent of all new manufacturing jobs were export related."

The importance of exports and the U.S maintaining its competitive position cannot be overstated from the standpoint of the economy and employment. The importance and contributions of DISC are clear.

IMPORTANCE OF DISC TO U.S. EXPORTERS

The importance of DISC to exporters is best stated by the exporters themselves. Attached as exhibit A are copies of letters received by the Special Committee for U.S. Exports from various small to medium size exporters this year. Examples of their comments are as follows:

"This country is like a babe in the woods when it comes to achieving parity in international trade relations and tariffs . . ." (Ahern International Sales Corporation, New Canaan, Ct.)

". . . without DISC many of our employees would have been laid off in the past and will be facing layoffs in the future." (Atlantic Wood Industries, Inc., Savannah, Ga.)

". . . export sales have grown from $4,189,000 in 1972 to over $20,000,000 in 1981 . . . of our 1,250 employees in the U.S., over 300 are directly tied to our exporting . . . deferred DISC income has been used to help expand our plant facilities three times in the past ten years." (A. T. Cross Company, Lincoln, R.I.)

"Since the formation of our DISC in January, 1972, foreign shipments have increased 300 percent. Estimated on sales per employee basis, these foreign shipments have supported approximately 240 jobs . . ." (The Durion Company, Inc., Dayton, Ohio)

". . . sell into 64 countries worldwide with export sales in excess of $5 million representing 35 percent of our total volume and responsible for the creation of approximately 125 new jobs." (Ferno Washington, Inc., Wilmington, Ohio)

". . . have experienced a substantial growth in export sales . . . compound annual growth rate of 17.8 percent. We are convinced that without DISC benefits this growth rate would not have been possible." (Milton Roy Company, St. Petersburg, Florida)

". . . of our total sales today 50 percent are derived from exports. Presently we are giving employment to a total of 175 people, which would be cut in half if we were to eliminate our exporting activities." (Whip Mix Corp., Louisville, Kentucky)

"We estimate we have created 125 domestic jobs which would have been filled by overseas personnel without existing DISC legislation." (Wiltron, Mountain View, California)

IMPACT OF DISC ON SMALL BUSINESS

There are both direct and indirect benefits to small business from DISC. The direct benefit applies when a small business has sufficient exports to create its own DISC. This can be achieved inexpensively through the use of a commission agent or by direct sales. In either case, the additional costs of the DISC are not great.

The indirect benefit of DISC is from orders by large exporters of material and parts from small business suppliers. In many cases, an export item by a large manufacturer will contain over 50 percent of its components from small business suppliers. For example, a study by Boeing found that since 1961, $11 billion of contracts were awarded to small business in all 50 States and that over half the value of

Boeing jetliners is produced by Boeing contractors, many of which are small business. This is just one example of a consistent pattern for exports of major manufactured items.

However, DISC could be made more beneficial to small business by increasing the percentage of DISC deferral for small business; increasing the exception from the incremental rules from $100,000 to $1 million or some other appropriate higher number; and eliminating reporting, formational and investment requirements for small business.

CURRENT LEGISLATIVE PROPOSALS

The attacks on DISC in Geneva have generated several proposals to modify DISC in order to bring it more into compliance with GATT. Two different approaches to the problem have been suggested so far.

One approach (contained in H.R. 5179 and S. 2708) would replace the present DISC system with an International Sales Corporation or Export Sales Corporation. The key distinction from DISC is the location of the corporation offshore whereas, a DISC must be a domestic corporation. The other proposal discussed by Ambassador Macdonald in a July 29, 1982 news briefing would replace DISC with a system providing relief from U.S. tax on foreign source income.

It is difficult to comment on the latter proposal because no detail has been supplied. However, it would be complex to work out for large exporters due to the interaction with other foreign tax provisions such as the investment tax credit. It would often be difficult for a small business to avail itself of such a provision. For example, many small business commission DISC's do not have foreign source income. Requiring foreign title transfer and other foreign source rules under the Internal Revenue Code would be difficult for small business to comply with.

The two bills primarily differ in their revenue costs. The House bill by adopting territoriality for certain exports without limitations carries a high revenue cost (without considering feedback). The Senate bill is geared like the Macdonald proposal to have the same revenue cost as DISC. It also contains specific measures to encourage small business use.

The Special Committee is studying the various proposals. The preference is to retain and expand the benefits under the present DISC system and simplify it for small business. However, if the U.S. is forced to adopt a new system, it is desirable that the export community work with the Congress in designing the new system to maximize the incentive and minimize technical and administrative problems.

From the standpoint of small business, the most desirable approach would be to exempt exports below a threshold figure from the new system and retain DISC or a simplified DISC for small business. Hopefully, a small business exception would be acceptable under GATT. In any event, care should be taken to make the new the new system attractive to small business.

CONCLUSION

Probably the greatest drawback to small business usage of DISC has been uncertainty. After DISC we enacted with great fanfair and support from the Treasury and Commerce Departments, it has been under constant attack and the benefits have been reduced several times. Considering the uncertainty, it is surprising that the number of small business DISC's has expanded over the years.

The Congress and administration should settle on maintaining and defending the present DISC or a similar incentive and make a policy determination that the system will be both promoted for small business and maintain at least at the present incentive level for the forseeable future. This would provide the certainty to encourage small business participation. The problems of confidence and simple, easily understood and administered rules for small business should be in the forefront of DISC discussions.

Finally, it is time that the U.S. recognize the importance of exports to the domestic economy and the well being of its citizens, other industrial nations have already adopted this policy. A straight forward U.S. policy to encourage exports and provide proper incentives to meet foreign competition is essential.

SPECIAL COMMITTEE FOR U.S. EXPORTS

RESPONSES TO MARCH 17, 1982 SCUSE LETTER

Company	Location
Adec	Newberg, OR
Ahern International Sales Corporation	New Canaan, CT
Atlantic Wood Industries	Savannah, GA
Canberra Industries, Inc.	Meriden, CT
Christianson Seed Co., Alf.	Mount Vernon, WA
Coherent	Palo Alto, CA
Committee for Small Business Exports	Aspen, CO
Consolidated Protective Coatings Corp.	Cleveland, OH
Cross Company, A.T.	Lincoln, RI
Data Card Corporation	Minneapolis, MN
Drake America Corporation	New York, NY
Duriron Company, Inc., The	Dayton, OH
Ferno Washington, Inc.	Wilmington, OH
Hobart Brothers Company	Troy, OH
Inductotherm Industries, Inc.	Rancocas, NJ
International Division Reliance Universal, Inc.	Louisville, KY
Jewett Refrigerator Co., Inc., The	
Milton Roy Company	St. Petersburg, FL
Phifer International Sales, Inc.	Tuscaloosa, AL
Sauereisen Cements Company	Pittsburgh, PA
Testing Machines, Inc.	Amityville, L.I., NY
UPA Technology, Inc.	Syosset, NY
Valsan International Corporation	New York, NY
Whip Mix Corporation	Louisville, KY
Wiley & Sons, Inc. Publishers, John	New York, NY
Wiltron	Mountain View, CA
Woodward & Dickerson, Inc.	Bryn Mawr, PA
Wynn Oil Company	Fullerton, CA

IMPORTANCE OF DOMESTIC INTERNATIONAL SALES CORPORATIONS TO U.S. EXPORTERS

Comments

"This country is like a babe in the woods when it comes to achieving parity in international trade relations and tariffs . . ." (Ahern International Sales Corporation, New Canaan, Ct.)

". . . without DISC many of our employees would have been laid off in the past and will be facing layoffs in the future." (Atlantic Wood Industries, Inc., Savannah, Ga.)

". . . export sales have grown from $4,189,000 in 1972 to over $20,000,000 in 1981 . . . of our 1,250 employees in the U.S., over 300 are directly tied to our exporting . . . deferred DISC income has been used to help expand our plant facilities three times in the past ten years." (A.T. Cross Company, Lincoln, R.I.)

"Since the formation of our DISC in January, 1972, foreign shipments have increased 300%. Estimated on sales per employee basis, these foreign shipments have supported approximately 240 jobs . . ." (The Durion Company, Inc., Dayton, Ohio)

". . . sell into 64 countries world-wide with export sales in excess of $5,000,000 representing 35% of our total volume and responsible for the creation of approximately 125 new jobs." (Ferno Washington, Inc., Wilmington, Ohio)

". . . have experienced a substantial growth in export sales . . . compound annual growth rate of 17.8%. We are convinced that without DISC benefits this growth rate would not have been possible." (Milton Roy Company, St. Petersburg, Florida)

". . . 50% of our total sales today are derived from exports. Presently we are giving employment to a total of 175 people, which would be cut in half if we were to eliminate our exporting activities." (Whip Mix Corp., Louisville, Kentucky)

"We estimate we have created 125 domestic jobs which would have been filled by overseas personnel without existing DISC legislation." (Wiltron, Mountain View, California)

2601 CRESTVIEW DRIVE • POST OFFICE BOX 111 • NEWBERG OREGON 97132 U S A • TELEPHONE 503/538-9471 • TWX 910 466 7031 ADEC INC NBRG

adec

April 14, 1982

Donald T. Regan
Secretary of the Treasury
15th & Pennsylvania Avenue NW
Washington, DC 20220

Dear Mr. Regan:

Over the past months we have been closely following developments related to activities centered around the status of the "Domestic International Sales Corporation" legislation.

We find it very disturbing to realize that this legislation might be repealed after many companies, including ourselves, have invested the time, money and effort required to establish DISC programs.

Surely the many benefits realized by American workers, economy and balance of trade far outweigh the reasons being stated as cause to repeal this legislation.

We therefore wish to urge you to take those actions required to assure the continued health of American DISC operations.

Very truly yours,

Gene Davis

Gene Davis
General Manager

wm

cc: Mark Hatfield
Robert Packwood
Les AuCoin
Don Bonker
Robert Chancellor
Nikolaj M. Petrovic

AHERN INTERNATIONAL SALES CORPORATION

March 25, 1982

Mr. Donald T. Regan
Secretary of the Treasury
15th & Pennsylvania Avenue, N.W.
Washington, DC 20220

Dear Mr. Secretary:

I am writing to you regarding the study scheduled to be completed by April 15th regarding the status of DISC. I would like to cite the example of this company as an examplar of why DISC should be continued and improved.

I formed this company with $5,000 capital in 1969 and we created a DISC in 1972. Our DISC averages about $10 million in sales per annum, exporting paper and paperboard primarily, two employees. Our $530,000 in deferred DISC taxes are a substantial part of working capital and have allowed us to participate in export markets characterized by sales on extended payment terms. It would be hard to imagine our maintaining this level of business without the financing tool made available through DISC as we receive virtually no support from the U.S. paper mills whose products we export.

This country is like a babe in the woods when it comes to achieving parity in international trade relations and tariffs, especially compared to Japan and the Common Market. DISC is the only effective tool supplied by our government. Don't destroy it.

Yours very truly,

R. C. Ahern (ga)
Richard L. Ahern

R.L. Ahern: ga
cc: Senator Lowell Weicker
Congressman William Ratchford
SCUSE ✓

Box 402 • New Canaan, Conn 06840 • Telephone (203) 966-3535 • Telex 965860 • Cable AHERNTRADE NEWCANAAN CONN

Atlantic wood industries
INCORPORATED
PRESSURE TREATED FOREST PRODUCTS P.O. BOX 1608, SAVANNAH, GEORGIA 3149
PHONE (912) 964-123-

March 30, 1982

The Honorable Donald T. Reagan
Secretary of the Treasury
15th and Pennsylvania Avenue, N.W.
Washington, D. C. 20220

Dear Mr. Reagan:

Our company, Atlantic Wood Industries, is a small business which depends a great deal on exports. In order to be competitive, the DISC has played a very important role. We understand that the DISC is being challenged on the basis of the cost effectiveness. We can only state that without DISC many of our employees would have been layed off in the past and will be facing layoffs in the future. The DISC is very important and we ask that we be allowed to have the same advantages as our European friends.

Very truly yours,

ATLANTIC WOOD INDUSTRIES, INC.

A. G. Labrot
President

AGL:er

xc: The Honorable Mack Mattingly
The Honorable Sam Nunn
The Honorable Ronald Bo Ginn
The Special Committee for U. S. Exports

Canberra Industries, Inc. 45 Gracey Avenue Meriden, Connecticut 06450 Tel. 203-238-2351 TWX: 710-461-0192

CANBERRA

April 13, 1982

The Honorable Donald T.Regan
Secretary of the Treasury
15th and Pennsylvania Avenue
Washington, D.C. 20220

Dear Mr. Secretary:

John Babson, Chairman of the Executive and Steering Committees of the Special Committee for U.S. Exports, has brought to my attention Deputy Secretary McNamara's doubts as to the cost-effectiveness of DISC. The DISC program has played a significant part in this company's ability to expand its exports and I wanted to share that experience with you and others who will be reviewing the program.

As you will see in the enclosed brochure, Canberra is a small, high technology supplier of scientific instruments and computer systems. Sixty seven percent of our business is overseas ($27 million) and DISC has played an important part in making our annual growth of 30% possible. For a small company like ourselves the cost of doing business internationally without DISC would place us in a non-competitive position with our European competitors. International sales require resources and financing which form an important part of the current DISC legislation. We would undoubtedly have to curtail a large measure of our international business were DISC to be eliminated or drastically altered. Most important however, it was largely due to DISC programs that we were able to develop and expand our overseas business, and I feel sure that the elimination of DISC would have a dramatic impact on other small firms who may be in the same position today as we were five years ago. I urge you to examine carefully the impact of DISC on small companies like ourselves.

There may well have been some abuses of DISC programs of which I am not aware, but from our experience these programs have been vital to our international expansion. Please consider any proposed changes very carefully.

If you would like more detailed information on the impact of DISC on our business, please do not hesitate to ask.

Sincerely,

Emery Olcott

Emery G. Olcott
President

O:ag
: J.Babson, SCUSE
E.Tisdale, SAMA
W.Ratchford
L.Weiker
C.Dodd

Alf. Christianson Seed Co.

60 YEARS A GROWER OF
QUALITY VEGETABLE SEED
FOR THE WHOLESALE TRADE.
MEMBER OF A.S.T.A. - S.S.A.
P.S.A. AND W.W.I.S.A.

PHONE 206/336-6622
TELEX: 32-1224
CABLE: CHRISEED
BANK: SEATTLE FIRST NAT'L
MOUNT VERNON BRANCH.

P. O. Box 98, Mount Vernon, Washington U. S. A. 98273

March 31, 1982

COPY

The Honorable Donald T. Regan
Secretary of Treasury
15th & Pennsylvania Ave. NW
Washington D.C. 20220

Domestic International Sales Corporation
DISC

Dear Mr. Secretary:

Contrary to the conception that only large corporations have benefited from the partial tax deferment provisions of the applicable Revenue Act of 1971 we, a comparatively small, family founded, family managed corporation have found the partial tax deferment provisions of substantial benefit in the fostering and development of our export business. We are vegetable seed growers, our principal crops are

Beet, Cabbage, Collards, Rutabaga, Spinach
Turnip, Carrot, Onion , Radish

crops which basically provide the vegetable needs of the world's millions.

Correlative beneficiaries of our expandible export potential are our farmer growers, some 165 of whom participate with us in individual contracts with our overseas customers.

Most of our growers farm relatively small family owned acreages, their participation in our expanded overseas business has made its contribution to the sustenance of our local agricultural economy.

Over the past seven full fiscal years since the establishment of our DISC our annualized dollar increment has averaged 81 percent; over the last three fiscal years our annualized dollar increment has declined to an average 75 percent.

During the last mentioned comparative period we have adversely felt the effects of foreign currency exchange disparities particularly those of Japan, Denmark, The Netherlands, France, Great Britain and Mexico to the U. S. dollar.

We, in our overseas markets are finding it increasing difficult to maintain our competitive position against foreign seed producers as a consequence of dollar equivalency disparities.

In lieu of all other warranties, expressed or implied (including any implied warranty of merchantability or fitness for a particular purpose), and all other obligations or liabilities, we warrant to the extent of the purchase price that the seeds we sell are as described by us on our container within recognized tolerances. Our liability whether contractual, for negligence or otherwise, is limited in amount to the purchase price of the seeds under all circumstances and regardless of the nature, cause or extent of the loss, and as a condition to any liability on our part, we must receive notice by registered mail of any claim that the seed is defective within 30 days after the defect in the seed becomes apparent. Seeds not accepted under these terms and conditions must be returned at once in original unopened containers and the purchase price will be refunded.

We need all the help we can possibly get to maintain our trade standing against aggressive competition from trading nations co-ordinated and supported in their national interests by their respective governments.

Mr. Secretary, we earnestly seek and would greatly appreciate your solid support for the retention of the partial tax deferment benefits enacted in DISC legislation.

Respectfully,

ALF. CHRISTIANSON SEED CO.

Robert MacDonald
Robert MacDonald
President

A. L. Christianson
A. L. Christianson
Senior V.P. - Treasurer

P. S. Since dictating the foregoing we have received this day within the hour from Malcolm Baldridge, Secretary of Commerce, teletyped advise of our being awarded the Presidents "E" Award for exports

> "in recognition of outstanding contributions to the increase of trade abroad"

Verbatim TT copy herewith. We are deeply honored.

R.M.
A.C.

COPY

CHRISEED MTVN

WU INFOMASTER 1-014942A090 03/31/82
ICS IPMPTUC PTL
ZCZC 03641 03-31 1102A PST
TLX 321224 CHRISEED MTVN
BT

1-0076641090 03/31/82
TWX US DOC WSH
0007 WASH DC MAR 31 82
PMS MR. ROBERT MACDONALD
PRIORITY
PRESIDENT
A.F. CHRISTIANSON SEED CO.
RAILROAD AND MILWAUKEE
MOUNT VERNON, WASHINGTON 98273

IT IS MY PLEASURE TO ADVISE YOU THAT YOUR COMPANY HAS BEEN SELECTED TO RECEIVE THE PRESIDENT'S "E" AWARD FOR EXPORTS IN RECOGNITION OF OUTSTANDING CONTRIBUTIONS TO THE INCREASE OF US TRADE ABROAD. MY SINCERE CONGRATULATIONS.
IN THE NEAR FUTURE OFFICIALS OF OUR SEALLTE DISTRICT OFFICE WILL CONTACT YOU TO ARRANGE FOR AN OFFICIAL ANNOUNCEMENT, APPROPRIATE PRESS RELEASES , AND FOR A PRESENTATION CEREMONY AT A MUTUALLY AGREEABLE TIME AND PLACE.

MALCOLM BALDRIGE
SECRETARY OF COMMERCE

1403 EST

NNNN
1409 EST

CHRISEED MTVN

March 31, 1982

Mr. John R. Babson
Chairman, Steering & Exec. Committees
Special Committee for U.S. Exports
1101 Connecticut Avenue, Suite 700
Washington, D.C. 20036

Dear Mr. Babson:

This is in response to your letter of February 17 in which you request comments on the repeal of the current DISC tax advantage.

Coherent is an $85 million company doing about 35% of our business in Europe and 10% in Japan. We are in a situation where the strong dollar is creating a very poor economic environment in which to compete in foreign countries. We find that a small amount of extra margin developed by the DISC tax advantage enables us to compete more effectively with our foreign competitors.

We feel very strongly that the DISC encourages exports and leads to advantages for both the company and the government. Please let us know if there is any additional information we can supply you with.

Sincerely,

James L. Donovan
Chief Financial Officer

JLD/mm

COHERENT 3210 Porter Drive • Post Office Box 10321, Palo Alto, California 94303
Telephone: (415) 493-2111 • Telex: 34-8304

COSBE
COMMITTEE FOR SMALL BUSINESS EXPORTS

March 30, 1982

The Hon. Donald T. Regan
Secretary of the Treasury
15th and Pennsylvania Av. NW.
Washington, DC. 20220

Dear Mr. Secretary:

We have just heard that Deputy Secretary R. T. McNamar has challenged the business community to justify the cost effectiveness of DISC by April 15, and that some business groups are getting together to develop an economic study.

We represent exclusively smaller companies involved in exports, and we only speak for smaller companies. It is too late for us to participate in the economic study referred to above, but we can assure you that from the point of view of smaller companies, particularly smaller manufacturing companies, DISC is absolutely crucial to their ability to go on struggling to build their exports. We do not have time to collect a lot of up-to-date specific examples, so we enclose extracts from more than 70 letters we collected from smaller companies a few years ago. It seems to us they speak for themselves.

DISC should be improved for smaller companies, by, for example, allowing 100% tax deferral for DISCs with up to $1 million of income, and by by increasing the small DISC exemption form the incremental rule up to the same limit. These changes would cost very little in terms of total taxes deferred, and would make a very big difference to many smaller, innovative and thrusting companies, the very type public policy should be trying to encourage.

Yours sincerely,

Richard C. Fenton
President

Post Office Box 6, Aspen, Colorado 81612. 303-925-7567. Cable Address: COSBE, Aspen, Colorado. In Washington, D.C.: 1101 Connecticut Ave. N.W., Suite 403

BOARD OF DIRECTORS: Richard C. Fenton, President, Fenton International, Incorporated Jack A. Bares, President, Milbar Corporation Charles J. Berthy, Vice President International Ledex, Incorporated Thomas P. Collier, President, Thomas P. Collier & Associates Stanley W. Epstein, Chairman, Anglo American Aviation Company Thomas M. Rees, Attorney at Law Washington D.C. Arthur A. Singer, President Singer Products Company, Incorporated James H. Smith, Executive Vice President, Coe Laboratories, Incorporated President: Richard C. Fenton Secretary-Treasurer: James K. Daggs, CPA Auditors: Alexander Grant & Company

consolidated PROTECTIVE COATINGS CORPORAT

1801 EAST NINTH STREET • CLEVELAND, OHIO 44114 • (216) 771-3258 • TELEX 98-0592 • CABLE· CONSOUTE U

OFFICE OF THE PRESIDENT

April 7, 1982

Honorable Donald T. Reagan
Secretary of the Treasury
15th & Pennsylvania Avenue, N. W.
Washington, D. C. 20220

Dear Mr. Secretary:

We understand that the Treasury will soon receive a study prepared by Price Waterhouse & Company related to the costs and benefits of DISC.

As a small business with a long standing and dedicated interest in international trade, we would like to emphasize to you that DISC has been of enormous and tangible benefit to our company in expanding the export of our products to overseas markets.

Because of the DISC benefits, on January 1, 1982, our company transferred all of its United Kingdom operation (previously supplied by our Canadian subsidiary with Canadian manufactured goods) to our DISC subsidiary. This transfer from Canadian to U. S. manufactured goods meant that $1 million worth of American produced goods were added to our DISC sales. Quite frankly, if it were not for the DISC benefit, we would have continued to export Canadian made goods which from a marketing point of view, had a somewhat more ready acceptance in the U.K. due to the special relationship between the U.K. and Canada.

Being a small business, we have been able to significantly increase our export sales because of the financing benefits that have accrued to us as a result of the long term tax deferral DISC benefit.

FINE
WRITING
INSTRUMENTS
Since 1846

A. T. CROSS Company

CABLE ATCROSS
TELEX [illegible]

ONE ALBION ROAD, LINCOLN, RHODE ISLAND 02865 U.S.A.
AREA CODE 401 333-1200

April 29, 1982

Mr. Donald Regan
Secretary of the Treasury
15th and Pennsylvania Avenues, NW
Washington, DC 20220

Dear Mr. Regan:

The A. T. CROSS Company is very interested in any action taken by the government relative to Domestic International Sales Companies (DISC'S). CROSS has grown tremendously over the years internationally as well as domestically, and two-thirds of our international sales still originate from Lincoln, RI. Our only foreign manufacturing plant is in Ireland.

Our Lincoln export sales have grown from $4,189,000 in 1972 to over $20,000,000 in 1981. We believe that of our 1250 employees in the U.S., over 300 are directly tied to our exporting. In 1972, we only had 594 employees.

Our deferred DISC income has been used to help expand our plant facilities three times in the past ten years.

The A. T. CROSS Export Company is a small exporter by multi-national corporate standards. We judiciously reinvest DISC tax deferred funds into the Company's foreign growth as new financing is required to expand our export operation. As additional capital becomes available, we have been able to provide more competitive credit terms to foreign buyers, increase our advertising and sales promotion outlays, and make new investments in longtime market development.

A. T. CROSS Company

In the last 15 months, our export growth has slowed dramatically due to: 1) the advance of the dollar, and resulting price increases our dealers have had to pay; 2) the loss of some key markets due to government trade policies and government changes, such as Iran, Nigeria, Brazil; and 3) general worldwide recession.

To remove the advantage of a DISC now, when exporters are facing the problems just mentioned, I feel is unwarranted. U.S. manufacturers are having enough problems exporting without worrying about the removal of the few advantages of a DISC.

Sincerely,

Russell A. Boss
President

RAB/kp

BCC: Mr. John Babson
Ingersoll Rand Company

DATA CARD
CORPORATION

April 1, 1982

Mr. Donald T. Regan
Secretary of Treasury
15th & Pennsylvania Ave., N.W.
Washington, D. C. 20220

Dear Mr. Secretary:

I am writing to earnestly request that you do not support the reported plans of the U. S. Treasury Department to seek a repeal of the Domestic International Sales Corporations (DISC) program.

Please let me briefly cite my reasons.

I am the board chairman of Data Card Corporation, a manufacturer and marketer of a line of high technology machines for business and industry including: equipment to emboss and encode plastic cards; specialized magnetic ink character (MICR) printing equipment; electronic weighing equipment; and automated laser machining systems. Our company was founded in 1969, and we have been a participant in the DISC program almost since that program was started in 1972.

The DISC program, as you know, allows participating companies to defer a portion of their tax liability on earnings from the sale of their goods abroad. As a practical matter, these deferred tax monies become increased working capital for the companies involved, which they can use to strengthen their export manufacture and sales operations. The overall goal is a steadily increasing volume of export sales for the United States, with the increased employment of Americans to make export goods, and the favorable trade balance-of-payment effects that inevitably result.

In the nine years Data Card has been a DISC participant, the total tax deferred monies involved for our company -- i.e., the increased working capital available to us over these years -- has been $4,165,000. A result has been an across-the-board strengthening of our export program, to include the development of products specifically for the export market, and the aggressive merchandising of these products.

The results, Mr. Secretary, have been impressive.

In our first year of DISC participation, our fiscal 1973 year, our company had only $526,000 in export sales, out of total sales of $4,832,000.

By 1976, three years later, export sales had climbed to $2,401,000, out of total sales of $14,553,000.

And in fiscal 1981, export sales were up again -- $9,904,000, out of total sales of $75,366,000.

The substantial gain in our export business over the years is obvious, as is, I believe, the fact that this has allowed Data Card to employ people it otherwise could not employ, while simultaneously contributing to an easing of the nation's balance-of-payment problems.

A key to all of this, Mr. Secretary, has been the DISC. Without DISC, Data Card would have had less working capital to expand its export program. We would not have been able to divert equivalent capital from our domestic program needs for this purpose. That's the way it is with young, growing companies like Data Card who are always in a "working capital crunch." In short, Data Card simply could not have developed as substantial in export program as it now has were it not for the DISC.

We keep hearing, Mr. Secretary, about government programs that "don't work." Well, here's one, the DISC program, that does work, and superbly so. Given the nation's unemployment and balance-of-payment problems -- and given the fact that DISC deals so effectively with these problems -- it is extremely difficult to understand why a repeal of DISC would be advocated. If the argument is that the Treasury is losing money because of DISC, that simply won't hold. The increased taxes generated by DISC-increased employment and business will far outweigh the taxes deferred under DISC.

While Treasury studies may cite a concentration of benefits among the larger companies as justification for the elimination of DISC, small companies like Data Card need this type of program to aggressively enter the export market. If smaller and mid-size companies are to realize their export potential, DISC must be maintained.

Again, Mr. Secretary, I earnestly ask that you not give your support to any DISC repeal attempt. Thank you very much for your consideration.

Sincerely yours,

W. K. Drake

Willis K. Drake
Chairman

Drake America Corporation
477 MADISON AVENUE · NEW YORK, N. Y. 10022
TEL (212) 758-5400 · CABLE DRAKAMERIC NY · TELEX DRAKE 233310

INTERNATIONAL MARKETING
AND MANAGEMENT

ROBERT L. STERN, PRESIDENT

April 2, 1982

The Honorable Donald T. Regan
Secretary of the Treasury
15th & Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Sir:

We understand that your office is interested in knowing the effectiveness of the DISC tax structure in encouraging and enhancing U.S. Exports.

Since forming a DISC in 1972, our company has increased its sales, i.e. the volume of U.S. goods we have exported, from $8,795,000 in our fiscal year 1972 to $70,812,000 in our fiscal year 1981.

To a significant degree, this was made possible by the incremental overseas marketing activities which we undertook, encouraged by the DISC legislation.

Considering the obstacles we, like other U.S. exporters now face in the form of high interest rates and high prices due to unfavorable exchange rates, we earnestly urge your consideration in not removing the one remaining support to U.S. Exports, i.e. the DISC legislation. Our export volume sustains some 170 jobs in our organization and hundreds of jobs among our suppliers.

Thank you for your consideration.

Very truly yours,

DRAKE AMERICA CORPORATION

Robert L. Stern, President

RLS:gr

cc: The Honorable Daniel P. Moynihan
The Honorable Alphonse P. Damato
The Honorable William Green
Special Committee for U.S. Exports ✓

DURCO

THE DURIRON COMPANY, INC.
SERVES THE PROCESS INDUSTRIES

REPLY TO: BOX 1145
DAYTON, OHIO 45401

March 31, 1982

Donald T. Regan
Secretary of Treasury
15th & Pennsylvania Avenue, NW
Washington, DC 20220

RE: Domestic International Sales Corporation

Dear Mr. Regan:

We are pleased to have this opportunity to present our views concerning the topic of Domestic International Sales Corporations. This type of United States corporation was established by the Revenue Act of 1971 to encourage the increased exportation of goods produced in the United States. We feel its survival is due to the fact that it has and continues to accomplish its initially stated objective.

Since the formation of our DISC in January of 1972, foreign shipments have increased from approximately $5.1 million in 1971 to $15.6 million in 1981, an increase of 300%. Estimated on sales per employee basis, these foreign shipments have supported approximately 240 jobs for The Duriron Company, Inc. in the United States.

Not only have shipments increased, but the DISC provisions have allowed us to conserve the capital necessary to support those shipments. These provisions result in no permanent tax differences, merely deferrals which continues only as long as the DISC continues its purpose of increasing exports and jobs.

There is a compelling need to continue the DISC as a partial offset to barriers created by foreign governments to protect their domestic industries from import competition.

We feel that the DISC has assisted us in increasing export sales, allowed for the capital growth necessary to support the sales, and created United States jobs. The DISC provisions have our full support.

Thank you for considering our interest and the interest of all the companies involved with United States Exports.

Very truly yours,

H. J. Gazeley
President & Chief Executive

tah
cc H. Metzenbaum T. Hall
J. Glenn J. R. Babson - SCUSE ✓

FERNO
WASHINGTON INC.
Wilmington, Ohio 45177
Phone 513/382-1451

ELROY E. BOURGRAF

April 5, 1982

The Honorable Donald T. Regan
Secretary of the Treasury
15th and Pennsylvania Avenue, N. W.
Washington, DC 20220

Dear Mr. Secretary:

Have noted that the Treasury Department is in the process of re-evaluating the cost effectiveness of the Domestic International Sales Corporation. Would like to apprise you of my personal experience of how this program has assisted in the growth of this small business.

We formed our DISC in 1972, at which time we had sales of about $5,000,000 including exports of $450,000.

The working capital provided through the DISC incentive played a large part, enabling us to promote our products world-wide and finance the growing volume. A dollar of export sales takes about twice as long to turn over as a dollar of domestic sales.

We presently sell into 64 countries world-wide with export sales in excess of $5,000,000 representing 35 percent of our total volume and responsible for the creation of approximately 125 new jobs. It is interesting to note that in Japan alone we expect to break the million-dollar mark in this fiscal year.

I can personally testify that in the case of Ferno-Washington the DISC program has accomplished the purpose for which it was conceived. Your consideration is appreciated.

Sincerely,

El Bourgraf

President

EEB:mp
cc: The Honorable John Glenn
The Honorable Howard M. Metzenbaum
The Honorable Willis D. Gradison, Jr.
The Honorable Thomas A Luken
The Honorable Bob McEwen
bcc: Mr. John R. Babson

HOBART

HOBART BROTHERS COMPANY / HOBART SQUARE / TROY, OHIO 45373 U.S.A. / PH. (513) 339-601 TELEX. 20-8265 • Arc Welding Systems/ Aircraft Ground Power Units / Industrial Battery Chargers

31 March 1982
Ref. REB-16214

The Honorable Donald T. Regan
Secretary of Treasury
15th & Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Mr. Regan:

I am most disappointed to read that the continuance of DISC is again in question and that its continuance is by no means assured.

We have been using DISC almost since its inception and have found it most valuable in expanding our export business. As I recall, before DISC came into existance, we were shipping about 15% of our production of electric arc welding machines overseas. Since DISC, we have had a steady growth each year and we are now exporting about 35 to 40% of these same products overseas. This export business is extremely important to us now considering the recession of the past two years and to lose the advantages of DISC now would be very damaging to our growth and jobs at our company.

Furthermore, I am sure you can understand that such off-again on-again policies make planning very difficult. We are thinking out five to ten years on markets and to do so intelligently we must know what we can count on - or we can't.

I would hope that we can resolve this problem once and for all and get back to the profitable business of exporting.

Sincerely,

R. B. Bravo - Vice President Corporate Development
HOBART BROTHERS COMPANY

RBB-js

cc: John R. Babson, Special Committee for U. S. Exports

INDUCTOTHERM INDUSTRIES, INC.
10 INDEL AVENUE RANCOCAS, NEW JERSEY, USA 08073

COPY

March 26, 1982

The Honorable Donald T. Regan
Secretary of Treasury
15th & Pennsylvania Avenue, N. W.
Washington, DC 20220

Dear Mr. Regan:

SUBJECT: DISC

Once again DISC is up for review and once again the less knowledgeable members of the Government question its value.

Selling overseas is tough and expensive. Not only do we have the usual competition from our U. S. competitors, but manufacturers from the other industrial countries get on the bandwagon and add to the competitive frenzy. Nearly all of these foreign competitors have government help in the form of outright grants, liberal low interest loans, or tax breaks. England generally has gone the route of low interest loans. Australia gives outright grants for the extra cost of overseas travel, selling expenses, brochures, etc. All Americans have is DISC and the value of that has been so diluted by the need to increase each year regardless of the economy that its effectiveness in spuring overseas activity and sales effort is waning.

However, don't even consider eliminating DISC. If you want to help our country, our economy, and promote jobs for our people, do what you can to broaden the benefits of DISC. Keep in mind that the strengthening dollar makes it tougher to compete overseas. The worldwide recession means there is less business available and keener competition for each order. Sales costs mushroom. To have to increase our volume in the face of these obstacles in order to enjoy some of the benefits of DISC is ridiculous.

It is time the Government recognized and fulfilled the need for encouraging this overseas effort if the jobs that depend on exports are not to be lost. Remember that the tax reduction there may be from corporations on their overseas earnings through the DISC program is offset manyfold by the domestic profits of suppliers that do not even know their material goes overseas and the workers whose jobs depend on these overseas shipments.

Very truly yours,

H. M. Rowan
President

HMR:jg

cc: Senator Bill Bradley
Congressman Edwin B. Forsythe

(609) 267-9000 TWX (510) 683-9392

International Division Reliance Universal Inc.

1600 Watterson Towers • 1930 Bishop Lane, Louisville, Kentucky 40218 • Cable Address: RELOU
Phone 502—459-9110 Telex No. 204353

April 6, 1982

Mr. Donald T. Regan
Secretary of Treasury
15th & Pennsylvania Ave.
N.W. Washington, D.C. 20220

Dear Mr. Secretary:

As Vice President and General Manager of the International Division of Reliance Universal Inc., I am writing to you to express my deep concern over recent actions by senior officials in the Treasury Department regarding the continuance of DISC. Our company has been successfully operating as a DISC Corporation by the name of Reliance International Sales Corporation, and we believe that small to medium sized companies greatly benefit by the tax deferral permitted under DISC.

The only help or assistance received from the U.S. Government to encourage export sales has been this tax deferral, and I strongly believe that in order to compete with foreign suppliers we must retain this limited assistance. The U.S. balance of trade is in a deplorable condition and with the continued strength of the U.S. dollar, we find it very difficult to compete in world markets. The only incentive we have is a small tax advantage which we must retain to have any interest at all in marketing our products overseas.

Your assistance in supporting the retention of DISC corporations will be greatly appreciated.

Yours truly,

RELIANCE UNIVERSAL INC.
INTERNATIONAL DIVISION

Gerald Painchaud

Gerald Painchaud
Corporate Vice-President

cw

BC: Mr. John B. Babson

Panelyte, Chemical Coatings Reliance Resins, Chemicals, Construction Materials

THE JEWETT REFRIGERATOR CO., INC.

April 8, 1982

U.S. Treasury Department
15th & Pennsylvania Avenue, N.W.
Washington, DC 20220

Attention: Donald T. Regan,
Secretary of Treasury

Dear Mr. Regan:

As you are, no doubt, aware the Special Committee for U.S. Exports is a group of both large and small businesses who are vitally interested in keeping the DISC program alive and well.

I understand from Mr. Babson's letter that Deputy Secretary R. T. McNamar is not totally convinced of the cost-effectiveness of DISC and has challenged us, the business community, to develop an economic study which addresses the costs and benefits of DISC.

I could go into a long dissertation on the history of our company, a small manufacturer, of refrigerators and related equipment for the health-care and scientific field, which would tell you how we developed from a very minor exporter of our products to a company who's exports will, this year, amount to almost 50% of our total business.

Our company is 132 years old and we have been exporting for many years, however, it was not until 1972, with the advent of the DISC law, that we took an aggressive position in the export market-place. In 1972 our exports amounted to between $700,000.00 and $800,000.00 and this year it's very likely that they will exceed $4,000,000.00. In your position I realize you are looking at billions of dollars of export, however, it is we small businessmen who make up the back-bone of the "yankee traders".

U.S. Treasury Department
Washington, DC
April 3, 1982

The DISC program has played a vital part in our use of tax relief funds, which we have poured back into the promotion of more products of our manufacture for sale in the international market-place. We have completely separated our international activities within the company from our day to day domestic activities and have a department of experts within the company who specialize in the promotion, documentation and shipment of export orders.

I, therefore, strongly urge that the DISC program, not only be maintained, but improved upon and I will be interested in your response to the export business community.

Thank you for your attention to my comments.

Sincerely,

THE JEWETT REFRIGERATOR COMPANY, INC.

Marshall L. Glickman
President

MLG:mm

cc: John R. Babson,
Chairman, Steering & Executive Committees
SPECIAL COMMITTEE FOR US.S. EXPORTS

cc: Karl D. Bays,
Chairman and Chief Executive Officer
American Hospital Supply Corp.

cc: Ted R. Mannen,
Director, Legislative Affairs
Health Industry Manufacturers Association

Milton Roy Company

Edgar A. Clinger
Vice President

April 2, 1982

The Honorable Donald T. Regan
Secretary of the Treasury
15th and Pennsylvania Avenues, N.W.
Washington, DC 20220

Dear Mr. Secretary:

In light of current developments concerning the continuance of DISC legislation, Milton Roy Company would like to take this opportunity to express our support for the continuation of the present DISC provisions of the IRS Code.

Since our DISC was established in 1973 we have experienced substantial growth in export sales, from $2,891,000 in 1973 to $10,751,000 in 1981. This represents a compound annual growth rate of 17.8%. We are convinced that without DISC benefits this growth rate would not have been possible.

Presently almost every major nation has various tax credits and/or tax incentives to promote export sales. If the United States were to discontinue DISC without immediately replacing it with another type of tax credit and/or incentive; then we as a nation would further put ourselves in a non-competitive posture in the world-wide markets. We have enough negative factors influencing our competitive position in these world-wide markets without deleting the economics of the tax deferrals available through DISC.

Our domestic economy is sluggish enough, so we should be taking positive actions which would promote business, both domestic and world-wide, and not actions which would have a further negative effect on employment, G.N.P., interest rates, capital formation, etc.

We strongly recommend that DISC legislation not be changed in any way. Continuance of existing DISC legislation will help assure continued expansion of our export program.

We are pleased to have this opportunity to express to you our feelings concerning this important issue.

Very truly yours,

Edgar A. Clinger

EAC:bd

cc: The Honorable Lawton Chiles
The Honorable Paula Hawkins
The Honorable C. W. (Bill) Young
The Honorable Sam M. Gibbons
Special Committee for U.S. Exports

One Plaza Place N.E., St. Petersburg, Florida 33701, USA
(813) 823-4444, Telex: 052-3459, Cable: MILROY
Mailing Address: P.O. Box 12169, St. Petersburg, Florida 33733

EXPRESS MAIL

PHIFER
INTERNATIONAL
SALES Inc.
K. GORDON LAWLESS, SENIOR VICE-PRESIDENT
MEMBER U.S. PRESIDENT'S EXPORT COUNCIL, APPOINTED 1981

April 1, 1982

Mr. J. Paul Lyet, Chairman
The President's Export Council
M. Sperry Corporation
1290 Avenue of the Americas
New York, NY 10019

Dear Paul:

At the initial meeting of The President's Export Council on October 15, 1981, some discussion was given to the status of the Domestic International Sales Corporation. This concerned the support to be given by the Council for a continuation of the DISC subject ot the decision of a review council established under the GATT scheduled to convene on December 8, 1981. This council convened to review a complaint that the DISC violated the subsidy probisions under the GATT agreement. Now that this council has met but side-stepped a permanent decision leaving the GATT open to future review, it is incumbent on the PEC to stand on the principle that the Administration should continue to support the DISC until a substitute is in place, one equally as effective as the DISC in promoting exports. I would hope that you would see fit to include a full discussion of this on the agenda for the May 14, 1982, PEC meeting.

It is my understanding that the Incentives/Disincentives Subcommittee chaired by Irene Meister discussed this subject at their subcommittee meeting of December 10, 1981, and that the committee voted to put forward a recommendation that the PEC ask the Administration to devise a strategy for the defense of the DISC should this issue be raised again in the international fora, or, if necessary, devise an alternative to the DISC. I understand that futher studies are being made on this subject by Mr. Philip Saxon of that committee.

There is a growing concern among many organizations about the fact that Deputy Secretary R. T. McNamar of the U. S. Treasury Department has raised the question of the cost effectiveness of the DISC and has challenged the business community to develop an economic study which addresses the cost and the benefits of the DISC. Presently several associations including the special committee for U. S. exports; National Association of Manufacturers; Emergency Committee for American Trade; The Business Roundtable; The National Foreign Trade Council; The Chamber of Commerce of the United States; and the American Business Conference have become so concerned over this

• P. O. BOX 1700, TUSCALOOSA, ALABAMA 35403 USA • TELEPHONE 205/345-2120 • TWX 810/729-5836 (PHIFER TULA)
TELEX 782504 (PHIFER TULA) • CABLE: PHIFER WIRE

challenge that an expensive expedited survey is being conducted to comply with a Treasury Department deadline for a study to meet this challenge by April 15, 1982. This is incredible in view of past and present positions of the Executive Branch in the Congress on this subject. The Export Imperative, submitted by The President's Export Council in the previous Administration, gave the following recommendation in December of 1980:

> As to the DISC, the Council recommends that the present DISC laws should be retained and improved to maximize DISC potential for stimulating exports and improving the nations balance of trade. Not only would this be responsive to the GATT situation that prevails (as described above) but DISC also has other important export advantages:
>
> > DISC provides working capital to exporters to finance longer term accounts receivable that are usual with customers in foreign countries; and
> >
> > DISC also provides funds to encourage risky long--term market development in new foreign growth areas.
>
> In a statement of the Chamber of Commerce of the United States on December 11, 1981, to the Subcommittee on Trade of the House Ways and Means Committee, the following position was taken in regard to the DISC:
>
> > Domestic International Sales Corporation (DISC) — The U. S. Chamber has actively supported the concept of the DISC since its enactment in 1971 and opposed any elimination or reduction of DISC benefits. We wish to reassert that position today and to call attention to the need for long-term certainty. Over this year, DISC's uncertain future has in itself been a disincentive to its use. Specifically, we recommend that the DISC be broadened by: eliminating the "incremental rule", allowing greater freedom of investment for DISC earnings, extending DISC eligibility to export trading companies, and expanding it availability to the service sector. Emphasis should be placed on a reasonable administration of tax laws which does not frustrate Congressional intent by being overly technical.

> It is quite possible that the DISC and the export tax systems of other countries may soon be acted upon by the General Agreements on Tariffs and Trade (GATT) Council. Regardless of the outcome of any GATT action, we maintain that preservation of the DISC (or a tax system at least as beneficial as it) is essential for an effective U. S. export program.

In the Chamber's December 31, 1981, Trade Policy Review, it advised that the DISC "promotes domestic employment by spurring exports, it contributes to the balance of trade and helps offset liberal tax benefits enjoyed by foreign competitors." "In its most recent report to the DISC, the Treasury Department estimates that the program has increased U. S. exports $4.5--7.0 billion since its inception."

"Perhaps most importantly, the DISC allows firms that are small to operate the foreign subsidiaries to enter the export field. From 1971 to 1979, over 7,200 DISC have been established according to the Treasury Department estimates."

Further the House Republican Research Committee reports in its "Economic Policy Task Force" the following:

> Since the enactment of the DISC, U. S. nominal exports have increased dramatically from $43 billion in 1971 to $220 billion in 1980. Export rade has become a more important component of the U. S. GNP, growing from 4.4% in 1970 to 8.2% in 1980. Export expansion has significant economic stabilization potential and is essential for the continued growth of the U. S. economy and the achievement of full employment in the context of a balanced federal budget.

A review of annual U. S. Treasury reports on the DISC indicates the number of DISCs grew incrementally each year to almost 14,000 as of February, 1981. The initial impact of the DISC in stimulating exports, according to the Treasury reports estimates, is from $1.9 billion in 1972 to $26.7 billion through 1979 (Table 1, page 4). Proponents of the DISC maintain the the DISC increases tax revenue directly through expanded exports, increased employment, and then secondary or "ripple" effects on the U. S. GNP. The most recent Treasury report (published April, 1981) departs from previous comparisons highlighting DISC limitations, and instead concludes that $4.5--7.0 billion of export value might be reduced if the DISC were lost.

Both independent economic analysis and that of the Department of Commerce agree that the DISC increases tax revenues. The direct revenue "loss" from the DISC tax deferrals is more than offset by the indirect benefit of increased GNP revenue gains. The Congressional Research Service of the Library of Congress mentioned a study under report 80-57A entitled "Tax Treatment of Export Income in the United States and Other Industrial Countries". This report speaks out on behalf of the DISC as follows:

> The DISC program has been used extensively by business. The most recent figure for the DISC program of the DISC year 1977 (part of the 1976 and part of 1977). According to those figures there are now 6,911 active DISC. More than 64% of U. S. manufactured exports were channeled through DISC. In the DISC year of 1977 this accounted for $82.681 billion of exports with a net income of $5.1 billion. The cost to the U. S. Treasury in terms of foregone taxes for the DISC year 1977 was about $754.8 million."

As Chairman of the Alabama Export Council, I have watched this Council year after year vote for a continuation and improvement of the DISC benefits because of the rising number of firms in Alabama that have joined the export community partially as a result of these DISC benefits. It is inconceivable in the face of the annual trade deficits that this country has suffered amounting to $36.4 billion in 1980 and $39.7 billion in 1981 that adversaries of the DISC at Treasury and the AFL-CIO continue to support its elimination without first having in place authorization that offers exporters equal or better tax treatment as an export incentive.

In the face of the latest round of criticism by Treasury officials, I feel like this matter should become a prime matter for discussion at our May meeting. I urge your approval that places this subject on the agenda.

Yours truly,

K. Gordon Lawless

K. Gordon Lawless

KGL:mh

cc: Mrs. Anna C. Chennault
Mrs. Irene W. Meister
Honorable Donald T. Regan
Honorable Malcolm Baldridge
Ms. Wendy Haimes
Mr. Howard G. Sloane

bc: ✓ Mr. John R. Babson,
Larry Suttles
Richard C. Fenton
Lionel Olmer
Richard McElheny
Gayle Shelton
Philip Saxon

ECIALTY CEMENTS SAUEREISEN CEMENTS Company INDUSTRIAL BONDING COMPOUND

PITTSBURGH, PENNSYLVANIA 15238 U.S.A.
Phone: 412/781-2323

April 21, 1982

Mr. Donald T. Regan, Secretary of Treasury
15th and Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Mr. Regan:

We understand the DISC program is being reviewed for continuance and/or expansion. As DISC is the only major incentive we believe the United States gives for exporting, particularly to smaller companies such as ours, we emphatically request it not only be continued but also expanded where practical. One suggestion is tax deferrals changed from fifty percent to one hundred percent.

Sauereisen Cements Company received the President's "E" Export Award, and exports have been an important part of our sales and profit volume for at least a quarter of a century. The inception of DISC several years ago gave us incentive for efforts which have resulted in retaining this important segment of our operations. Therefore, please at least continue the DISC program and, where practical, increase its tax deferrals to one hundred percent.

Your acceptance of this request would be highly appreciated.

Very truly yours,

SAUEREISEN CEMENTS COMPANY

Phil F. Sauereisen

Phil F. Sauereisen
President

sae

TESTING MACHINES INC.
THE FINEST TEST EQUIPMENT FOR ALL INDUSTRIES

W. F. BACHELDER
PRESIDENT

400 BAYVIEW AVENUE
AMITYVILLE, L.I. NEW YORK 11701
(516) 842-5400
TELEX 96-1302

April 8, 1932

Mr. Donald T. Regan
Secretary of the Treasury
15th & Pennsylvania Avenue N.W.
Washington, D. C. 20220

Dear Secretary Regan:

It concerns we greatly that the administration and other interested parties are considering radical modification of the Domestic International Sales Corporation program.

Nearly since its inception, our DISC Corporation (TMI Export Inc.) has actively pursued foreign markets. Our activities had produced a spectacular increase in total sales where exports accounted for a minimal 1% of our $10,000,000 a year business to now approximately 25%.

We have taken advantage of every sales medium possible including the use of our own commerce department activities in various countries.

In the development and manufacture of our equipment, we now have a policy of adhering as closely as possible to international standards, and to make our equipment compatible with foreign markets. The interest in the interchange of technical knowledge and the increase of our exports would not be as attractive to us, nor as feasible, without the help of our DISC Corporation.

Presently in our office we have three people exclusively working on our export program. In addition to the administrative phase, this is backed up by nearly 10% in our manufacturing operation. These people would have their earning power and positions jeopardized, if our company felt it inadvisable to proceed in developing export markets.

- cont'd -

TESTING MACHINES INC. TMI

Secretary of the Treasury
April 3, 1982
Page 2.

Although it may be a question of opinion, I firmly believe that an exchange of business by our firm with over 50 countries throughout the world cannot but have a beneficial influence on the general political atmosphere. We are technically oriented and it is to the advantage of the United States to obtain and enlarge a foothold in technical developments in as many countries as possible. DISC makes a positive contribution in this area.

I trust you will give careful consideration before supporting the abandonment or radical modification of this valuable export program.

Sincerely yours,

TESTING MACHINES INC.

W. F. Bachelder
President

WFB/rn

UPA Technology, Inc.

60 OAK DRIVE
SYOSSET, NEW YORK 11791
Telephone 516-364-1080
Telex 14-3115

April 8, 1982

Donald T. Regan
Secretary of the Treasury
15th & Pennsylvania Ave., N.W.
Washington, D.C. 20220

Dear Sir:

It was recently brought to our attention by the Special Committee for U.S. Exports (SCUSE) that certain new developments could lead to significant changes or repeal of the Domestic International Sales Corporation tax defferal program.

Indeed, we feel this would be most unfortunate as the DISC has played a major role in the development and expansion of U.S. exports and in the ability of American companies, like our own, to compete in world markets.

As a small company engaged in the manufacture of sophisticated measuring instrumentation for quality control and inspection purposes, we continue to be most encouraged by the DISC program. At present, about 40% of our volume is exported, and we are looking forward to continued growth in the sale of our equipment to foreign markets, with consequent increased employment.

We are presently engaged in starting a new office building adjacent to our present plant that will double our working space and permit us to do more Research/Development/Engineering so that we can bring new and elegant products to world markets and compete more effectively on an international scale.

We urge you to take whatever action is necessary to preserve the DISC program. It is vital to the survival of small companies during these hard economic times, and well serves the nation at large.

Very truly yours,

Sidney Lieber

Sidney Lieber
President

SL:es
c.c. Rep. Norman F. Lent
SCUSE ✓

THE LEADING PRODUCER OF AMERICAN MADE PLATING AND COATING THICKNESS MEASURING INSTRUMENTS

TELEX: 424733
CABLE ADDRESS "COVALSAN"

VALSAN INTERNATIONAL CORPORATION
43 WEST 61st STREET -- NEW YORK, N. Y. 10023
TELEPHONE (212) 581-9672

April 13, 1982

Special Committee for U.S. Exports
1101 Connecticut Ave., Suite 700
Washington, D.C. 20036

Att: Mr. John R. Babson, Chairman
Steering & Executive Committee

Dear Mr. Babson:

We received your letter of March 29, 1982 and noted with great interest your comments relative to your continued activities on behalf of the DISC program.

We have continued to increase our export sales of U.S. products and directly attribute this increase in sales to the benefits of the DISC program. Since our last communication to you in 1978, our export sales have increased by 114%. This has resulted in increased employment in our company, as well as that of our major supplier, a pump manufacturer in Ohio. In spite of a decrease in their domestic sales due to present economic conditions in this country, they have maintained a double shift of workers in their production department due to increased export sales generated by us under this DISC program.

The availability of additional funds to us because of the tax deferral under the DISC program has enabled us to spend more money for overseas travel, advertising and participation in trade shows. We would not have been able to do this if we had not received the benefits of this tax deferral program.

We appreciate your efforts on behalf of our company and the many other medium-sized exporters and manufacturers who have benefited from this DISC program and trust that you will be successful in your efforts to convince the present administration and Congress to continue this very worthwhile program.

Very truly yours,
VALSAN INTERNATIONAL CORP.

S. SANDLER
PRESIDENT

VS

Whip Mix
CORPORATION
361 Farmington Ave. • P.O. Box 17183 • Louisville, Kentucky 40217 • Phone (502) 637-1451

April 7, 1982

Mr. Donald T. Regan
Secretary of the Treasury
15th & Pennsylvania Avenue, N.W.
Washington, DC 20220

COPY

Dear Mr. Secretary:

It is my understanding that your Department again is questioning the value and importance of the continued existence of DISC's in the development and promotion of U.S. export trade. I feel certain that you and your Department realize the significance of U.S. exports for our trade balance and also for the well being of U.S. industry.

As a member of the District Export Council in Kentucky since its inception in 1970, I have been able to observe from close by the important contribution export sales have and the influence they exercise on the economy within our Commonwealth. In order to maintain this momentum and to possibly develop new markets overseas, the continued implementation of DISC legislation is of the utmost importance. DISC legislation is the only tool we have at hand to give manufacturers a potential incentive to promote exports of their products.

Our own firm has been engaged in active exporting for about 30 years, and close to 50% of our total sales today are derived from exports. Presently we are giving employment to a total of 175 people, which would be cut in half if we were to eliminate our exporting activities. Because of continued and serious efforts on our part, we have been able to maintain our overseas sales volume despite heavy foreign competition and the ever increasing cost of the U.S. dollar to foreign purchasers. Our DISC has allowed us to maintain a level of cash, in turn making it possible for us to grant favorable terms of payment to foreign customers, while maintaining an even level of pricing. Without the existence of a DISC, this would be most difficult, if not impossible -- for lack of cash resources or the necessity for borrowing funds at relatively high rates of interest.

Whip Mix
CORPORATION
361 Farmington Ave. • P.O. Box 17183 • Louisville, Kentucky 40217 • Phone (502) 637-1451

Mr. Donald T. Regan April 7, 1982

Our situation is not unique, and many medium-size manufacturers like ourselves find themselves in the same position; only the incentive of a separate DISC spurs us on to invest effort and money in promoting and developing more and bigger exports. Ultimately, we hope that they contribute to the economic well being of our country.

To sum up, in order to remain competitive in foreign markets and to provide the necessary stimulant and incentive to U.S. manufacturers and exporters, I must consider the continued existence of DISC legislation of overriding importance.

COPY

Sincerely,

WHIP-MIX CORPORATION

Harvey W. Sollinger
Vice-President

HWS:gmb

cc: Special Committee for U.S. Exports
1101 Connecticut Avenue
Suite 700
Washington, DC 20036

Congressman Gene Snyder
House of Representatives
Washington, DC 20515

605 Third Avenue
New York, NY 10016
212-867-9800
Telex 12-7063
Cable IONWILE
New York. Chichester.
Brisbane. Toronto

John Wiley & Sons, Inc. Publishers

Charles B. Stoll
Vice President

March 29, 1982

Hon. Donald T. Regan
Secretary of Treasury
15th & Pennsylvania Ave., N.W.
Washington, DC 20220

Dear Mr. Secretary:

I am writing to urge your support of the continuance of DISC, which I understand is currently under review.

As a publisher of educational, scientific and technical books and journals, my company has, through its export sales network, provided information and service to both the developed and developing worlds. I think you can appreciate that publications supporting education and technological development have a value far beyond the purchase price.

Because international sales are an important part of our business, Wiley established a DISC shortly after the program was initiated. It has enabled us to grow in export markets, and has assisted in the maintenance of reasonable discounts and prices. We believe its continuance is well warranted by the experience we and others can demonstrate.

Sincerely yours,

Charles B. Stoll

CBS:ff

CC: Hon. Alfonse D'Amato
Mr. John R. Babson
Hon. Daniel Patrick Moynihan

WILTRON

805 East Middlefield Road
Mountain View, California 94043-4085
Telephone: (415)969-6500
TWX: 910-379-6578

7 April 1982

The Honorable Donald T. Regan
Secretary of the Treasury
15th and Pennsylvania Ave., N.W.
Washington, D.C. 20220

Dear Sir:

It has been brought to our attention that senior officials of the U.S. Treasury have proposed the elimination of the DISC because of its lack of "cost effectiveness." We are in favor of retaining existing DISC laws for the following reasons:

1) They have created new domestic jobs.

2) They have been a positive factor in the U.S. balance of payments.

We feel that our own situation is typical of many U.S. businesses, and the facts concerning our export operations are outlined below.

WILTRON Company is a small manufacturer of electronic test equipment with $30 million annual sales. In 1981, our export sales amounted to 40% of our total volume. We trust you will appreciate that achievement of this high export/domestic sales ratio required considerable effort and investment on our part. Without the benefits of the existing DISC laws, we could not have maintained the investment to achieve this volume of sales.

Prior to the enactment of the DISC legislation in 1971, we had planned to build an overseas assembly operation to take advantage of favorable labor rates. The incentives offered by DISC status convinced us to concentrate on domestic production and export of our products.

The results have been the expansion of our domestic work force, and an increased emphasis on our export business. We have increased our exports from $545,000 in 1972 when our DISC was established, to $2.9 million 6 years later in 1978, and to $12 million in 1981. This is a substantial growth pattern which we expect to see continue in 1982.

We estimate we have created approximately 125 domestic jobs which would have been filled by overseas personnel without existing DISC legislation. We have been able to achieve this significant expansion through increasing our overseas marketing effort, since direct incentives are provided in the law for export promotion expenses. The additional capital available to our company in the form of deferred taxes has to carry our foreign accounts receivable for the longer payment period demanded by most of our export accounts.

We feel the DISC legislation is a much better incentive than import duties and quotas in our industry. Our company would definitely reduce its emphasis on export sales if DISC statutes are repealed, and would again be forced to consider the establishment of an overseas assembly operation. We are of the opinion that other companies with similar operations would do the same. This undoubtedly would result in further domestic unemployment, and further deterioration of the existing balance of payment situation.

Respectfully Submitted,

WILTRON COMPANY

James D Hice

James D. Hice
Export Marketing Manager

cc: Senator S.I. Hayakawa

ESTABLISHED 1873

Woodward & Dickerson
Inc.

WOODWARD HOUSE
937 HAVERFORD ROAD
BRYN MAWR, PA. 19010 U. S. A.

CABLE "WOODWARD"
TELEPHONE
AREA CODE 215 527-5200

TWX 510-662-3381
WU TELEX 084-5244

April 5, 1982

Donald T. Regan
Secretary of Treasurey
15th & Pennsylvania Ave.
North West,
Washington, D.C. 20220

Reference: DISC Provisions in U.S. Tax Law.

Dear Mr. Regan:

We are again hearing rumblings from Washington, and growing louder, about doing away with or, at least, reducing the benefits which result from the existing DISC Provisions in the U.S. Tax Code. If these benefits are eliminated or in any way changed to reduce the benefits to U.S. exporters, you will mangle one of the principle tools available to U.S. exporters battling competition around the world.

We are a merchant trading firm and have been active for over 100 years. As we have grown we have opened branch offices or subsidiaries in 14 countries abroad. In the course of our trading operations, where at all possible, we will quote origin our product of the United States rather than the product of some other country unless circumstances make such an offering totally impractical. At times economics dictates that the United States produced product cannot compete. Geography sometimes dictates this-except in most unusual circumstances it is generally going to cost less to deliver something in Southeast Asia which has been produced in Australia or North Asia, than from the United States.

To some extent overseas buyers will pay more for a product of the United States simply because that product, quite often, is of better quality.

The figures below, in Millions of U.S. Dollars indicate the importance of exports from the United States from our total sales. When we consider our totally domestic business, plus that which is totally offshore, the relative of importance of exports in magnified.

SALES

FY ENDED	TOTAL	EXPORT	% EXPORTS
1981	198	85	43
1980	170	87	51
1979	164	91	55
1978	131	73	56
1977	81	50	62
1976	107	61	57
1975	156	104	67
1974	114	34	30
1973	41	19	46
	1,162	604	52

You will observe that a high point was reached 1975/77 period; the percentage thereafter tends downwards. This tendency cannot be attributed to any one factor but as one or more edges of our tools are dulled the fight for the export market becomes more difficult.

We have enough obstacles in exporting due to labor rates in the United States in general and Stevedoring rates inparticular. Tax incentives offered to exporters in competing industrialized nations are deliberately geared to give that country an advantage. Those tax advantages are generally immediate and final; our existing DISC is a deferment only of ½ of the regular tax-some day, payment must be made.

The export insurance schemes offered by many of the major industrialized nations are, often times, better than that afforded us by FCIA and the Export Inport Bank programs. Japan will always be a tough competitor because of the many inducements offered by their government to exporters and also the fact that the Japanese will work for a miniscule percentage at the bottom line-sometimes as small as .03% of sales.

. . . 3/

If the benefit of DISC, imperfect as it is now, is reduced, it is bound to have its effect on the volume of exports from the United States.

We urge you not only not to diminish the present provisions of DISC but, rather, increase them. We don't ask for advantages greater than those of our competitors, simply to increase what we have so that we are not as far behind our competitors as we are as of now.

Yours very truly,

H.J. Keefrider
Vice President

cc: Senator John Heinz
Senator Arlen Specter
Representative Richard T. Shulze
Representative Charles F. Dougherty

wynn's
WYNN OIL COMPANY
2600 EAST NUTWOOD AVENUE, P.O. BOX 4370, FULLERTON, CALIFORNIA 92634 • (714) 992-2000 CABLE ADDRESS WYNNS

March 26, 1982

Special Committee for U.S. EXports
1101 Connecticut Ave. Suite 700
Washington, DC

Gentlemen:

Wynn Oil Company wants you to know we strongly support the continuation of DISC. This functional business benefit has assisted Wynn Oil Company to export products to more than 80 countries and twice we have received the President of the United States "E" Award for Excellence in Exporting.

Sincerely,

WYNN OIL COMPANY

Roger N. Tumbleson
Vice President, Operations Research

RNT:mb

Mr. NOWAK. Thank you very much.

Let me just ask a few questions before we call our other witnesses.

We had talked about that it has not been determined that DISC is GATT-illegal as of the present time.

Mr. JACKSON. Right.

Mr. NOWAK. Going through another round in October.

Mr. JACKSON. Right.

Mr. NOWAK. I am just, curious about whether Europeans, because of pressure of steel and other products coming into this country, are now using DISC as a, let's call it a leverage, to not open up the question of that list of so-called subsidies that I read on the countervailing petitions that have been filed by the steel companies.

Mr. JACKSON. I think it is unfortunate the way things have evolved for a number of years. People talked about DISC as a bargaining chip to bring other country systems into line, and now they sort of turned the table and made it a bargaining chip to prevent us from doing things, so not only did we not obtain anything by trying to modify our law, it has been turned around and used against us.

I don't know how negotiating over the years we have gotten into that posture, but I think it is a very unfortunate posture and I would agree.

Mr. NOWAK. It is almost amazing. Do you see any substantive reason for setting up the territorial or offshore corporation, as they have done in Europe, and declaring that it is GATT-legal, and ours is GATT-illegal because we have the word "domestic" on ours? In other words, even if we went through this and set up this territorial, shouldn't the result and the impact to the exporting company be approximately the same?

Mr. JACKSON. There is no question about it. My understanding, from talking to people that have been involved in the Geneva negotiation, is that the other countries have taken the position that we have some very good arguments on the substance, but they are not going to listen. They have got us on the technical argument that technical language of the law, of the GATT Code, is what they are going to follow and the efforts by Ambassador MacDonald and others to bring in the true substance that there is no difference is being essentially ignored and they are just focusing on certain words in it, but as a practical matter, there is no difference. One or the other. All we are talking about really with the Frenzel bill is moving essentially the DISC offshore.

Mr. NOWAK. I am just wondering if your organization could present the subcommittee other methods which, at least in terms of the GATT legality questions, could pass that test, and yet provide some type of increased incentives for exporting other than the DISC itself, or in addition to, or modifications of, the territorial bills that have been presented? Have they met on those questions now that this is coming to a collision with our interests?

Mr. JACKSON. I would say that meetings are going on in our organization, plus a number of other export-concerned organizations around town. We met yesterday, in this session, and are exploring alternatives, and will continue to do that.

It is very difficult within the restraints we put around ourselves in the GATT negotiation to come up with a domestic system other than there is a provision that you can charge interest on a deferral, and that would be GATT-acceptable. Whether that could be structured in such a way as to make it a similar incentive as the DISC is a question. It is one alternative that has been talked about. The other alternative that Ambassador MacDonald talked about would be having foreign source income not taxed to a certain extent without having to go offshore.

The problem is for small business having to change the place of sale and other types of technical rules in order to comply with the Internal Revenue Code provisions on what is foreign versus domestic source income.

So, we viewed that as equally complex, if not more complex than the offshore provisions.

Mr. NOWAK. But if we go offshore, I think it would be difficult, because of the complexity of present DISC for a small corporation to set up a subsidiary.

If we go offshore, I would envision that it even gets a little more complex, trying to accomplish the same thing, and there possibly will be some exemptions based on size of exports, both out of the Ways and Means and out of the Senate. We would appreciate it if your organization would look at that. I understand you have about 1,200 business concerns and associations involved in this whole area of exporting, and I wonder if you could get us any detailed information to bring to the attention of everyone the amount of subcontracting that goes into specific products that are sold.

You know, the question of how much participation a small business really has in all this. If they are not doing it themselves, they are certainly supplying some of the parts and equipment to the DISC corporations.

It also would be interesting to see a breakdown, if that was possible, as to small- and medium-sized business participation, the impacts, even though they are not DISC-related.

Mr. JACKSON. Boeing did a study that I put in the testimony. I think several other companies have done that type of thing, where there is an export of an item that has a lot of components I think that is a very interesting aspect of how small business comes in.

Mr. NOWAK. OK. Mr. Centner?

Mr. CENTNER. One thing that puzzles me is, as the chairman mentioned, and as you mentioned in your testimony, other countries are engaged in direct subsidies that are far more blatant than DISC. Why aren't we going after that as the root problem, rather than trying to find a way for ourselves to do the same thing?

Mr. JACKSON. Well, you almost get philosophical at times. The United States, in its international policy, has always been a very idealistic country, to say the least, and we have believed in the principles of free trade and other things. We have gone way out with an effort to make the world a better place for trade, et cetera, where other countries go for whatever nitch, and defend it to enhance exports.

There are so many of them, and they are so hard to quantify. I think recently, as was read earlier by the chairman, a great many more of them are being pushed than before. We did not push a great many things for a period of time, because we wanted the MTM. I am not sure exactly what we got from the Tokyo round. I mean, you ask somebody now, what does the procurement code achieve—which was one of the mainstays of it—and they say, "Well, we got nothing." At least I have not found anybody that says we achieved anything.

So I think, in part, there was a hiatus for a period of years where we were not pushing cases, and now we are pushing more cases and they are trying to push back. That is one of the problems that DISC is facing.

I think we could do a better job. I think we need to make the decision that we are in a competitive position, and this country is going to do everything to push our own people, as well as the ideals. As long as we don't have the utopian ideal in world trade and the rest of it, you can still work to achieve that. On the individual cases and the rest of it, we have got to be just as tough and just as protective of our exporters as they are. That is a decision, I think, this country needs to come to very badly.

Mr. CENTNER. It seems like we are the ones always doing the adjusting. Why aren't they doing the adjusting. Why don't we just say "you guys are wrong, we don't want to be wrong with you, we want us all to be right," and push it from that side? Certainly, we have some kind of economic clout in the international community. Are you saying that there are just too many of them to do that?

Mr. JACKSON. Well, you know, it is hard to say, because, we are talking from the standpoint of trade. The whole international situation gets involved with politics, the State Department, and other agencies of the Government. You look at something like the recent example of the Russian pipeline. That may be very good military, international, other policy. I am not an expert on that.

From the standpoint of trade, it is costing this country $1 billion-plus in sales, and I am sure there are many jobs related to that. Not only that, but during the time that we may achieve in delaying the pipeline, other people will be gearing up to manufacture those items. So, we are creating competitors for ourselves. That is the trade side, and frankly, the people who made the decision I hope recognize the trade side, but they have said, these other things counterbalance it.

We have got such a bundle of problems because of our stature in the world that unfortunately trade quite often comes last, I think. I think that is the problem. If we could bring it up to a higher level, and get more consistency in doing what you are saying, defending our rights, and pushing back and not having the first real issue that comes before the MTM and the DISC, I think those are the things we badly need to do. But we have to work it out with all of the problems in our system.

Mr. NOWAK. Thank you very much, Mr. Jackson. We appreciate your time, and hopefully, as we get into looking at alternatives in ways to reduce the complexities and mechanics of DISC in general, and we start to revise because of the broader problems that you have stated, we will still retain some incentive.

Because I think if DISC goes, there is going to be little else to support broadening the exports that we have now, and as the balance-of-payment situation just gets worse and worse. We appreciate your time, and we are going to hold the record open. If we have further questions, we may submit them to you.

Mr. JACKSON. Well, thank you. I will be very pleased to do that.

Mr. NOWAK. Thank you very much.

Our next witnesses will be from the National Ocean Industries Association. If they will come forward.

Mr. Frank March is the president and chief executive officer of Seaward International, Inc. of Falls Church, Va. Seaward International, which owns its own DISC, is a manufacturer of marine fendering and flotation equipment. He will be accompanied by Leonard Kriss, who is a partner in the law firm of Diebold, Millonzi, Raiser & Robshaw, which has offices in Washington, D.C., and Buffalo, N.Y., and is a tax expert, who has given us valuable assistance and testimony on other tax problems that this committee has had to wrestle with. So we welcome you both before the committee, and your complete statement will be inserted in the record.

Mr. March.

TESTIMONY OF FRANK A. MARCH, PRESIDENT, SEAWARD INTERNATIONAL, INC., FALLS CHURCH, VA., ON BEHALF OF NATIONAL OCEAN INDUSTRIES ASSOCIATION, ACCOMPANIED BY LEONARD KRISS, ATTORNEY

Mr. MARCH. Thank you, Mr. Chairman.

Since the statement will be inserted in the record, I will merely summarize some of the principal parts that are in it.

There are several questions which I have addressed specifically, and some of these may overlap some of the other speakers. Specifically, they are: (1) Why do we need to export, (2) why do we need to provide export incentives for small business, (3) what are the pros and cons of our current export incentive programs, and (4) how do the legislative proposals that are on the table address these needed changes in the programs? First, why does the United States need to export?

The primary reason is to create new jobs. Approximately 80 percent of all new manufacturing jobs are related to exports. A simple calculation shows that if we could double our exports, we could cut this country's unemployment rate almost in half. A second reason is to reduce the U.S. trade deficit, and a third reason is to increase our commercial presence abroad which can enhance our political presence abroad. If we can increase U.S. competitiveness and return the overvalued dollar to a sense of balance, this will help achieve these objectives.

Second, why do we need to provide incentives for small business to export? Small business offers the greatest growth opportunity for our exports, and the greatest chance to improve these factors of unemployment, trade deficits, and increased commercial presence abroad.

The Commerce Department, in a study, has estimated that at least 20,000 small business firms could export, but do not do so now. For small businesses, the initial barriers to entry to export, specifically, information about export markets and high costs, are proportionately higher than they are for large firms. Our own experience, and this is for my company, Seaward International, Inc., is that expenses to develop an export market are typically twice as much as those for a domestic market. To give you an example, it now costs approximately $600 per day to send a U.S. salesperson on a foreign sales trip, compared to less than half this much for a U.S.-based salesperson who is traveling the United States, for sales purposes.

This same factor of two applies to all the other types of expenses, such as trade shows, advertising, foreign language literature, foreign patent filings, a host of other expenses. It is for these reasons that tax incentives can help, particularly for small business.

The next point I would like to address is what are the pros and cons of current export incentive programs? Our only real export tax incentive, the DISC, has helped many businesses increase their exports substantially. It is estimated that exports attributable directly to DISC increased from $1.9 billion in 1972 to almost $7 billion in 1979. To bring this close to home, an experience of my own company, Seaward International, shows the benefits a DISC can produce. When we first established a DISC 4 years ago, exports were only 36 percent of our total sales. Today, exports constitute over 70 percent of our total sale. Our domestic sales have grown only 26 percent in this period, while our export sales have grown 424 percent, over five times what they were 4 years ago. This dramatically shows the value of export tax incentives.

I might add that the U.S. Treasury has not suffered at the expense of my company's export sales growth. Over the same period, our annual Federal tax liability went up over 600 percent. That means the Treasury is getting from my company seven times as much as it was getting 4 years ago.

This, of course, does not even include the additional personal income taxes or payroll taxes on the company's personnel which have also grown substantially. Overall, it has not been a bad return to the Treasury on a so-called tax break.

As I am sure Price Waterhouse will testify, a recent study for several business groups indicated that because of revenue feedbacks, the Treasury receives $1.24 in additional revenue for each dollar of DISC, in terms of revenue foregone. If the experience of my company is any indication, this dollar return value could be substantially higher. In other words, the Treasury could be getting a much greater benefit than $1.24 for every dollar of DISC.

Obviously, we will have to make some changes in U.S. export tax incentives. Any proposal will have to address the GATT objections, and that is a primary factor. It will have to be a lasting and durable policy, so that the mere uncertainty over its continued existence does not provide a disincentive for its use, as has been the case with DISC for many exporters. It should be relatively simple and easy to administer. Hopefully it will be a lot simpler than DISC. It should retain or amplify the provisions of DISC for small or newly established exporting companies, in order to continue the incentives for these companies to begin exporting. Finally, I would like to address how the current legislative proposals address these needed changes. There are two bills which offer alternatives to DISC, S. 2708, introduced by Senator Boren, and H.R. 5179, introduced by Congressman Frenzel. Both bills make a good start at addressing the required changes in DISC. However, both bills have certain shortcomings. Congressman Frenzel has addressed a number of these shortcomings in his testimony this morning.

I will briefly touch on ones that we find objectionable. I think many of those are addressed in his testimony. The bill does not allow related party transactions, and this provision should be dropped. He has indicated he is planning on doing that. Under the bill, an international sales corporation cannot have an office in the United States. This increases the administrative complexity for small business, and he has indicated there may be some changes there.

There is a 1-year phaseout period proposed for DISC's in the bill. We feel this is too short and should be expanded to 5 years.

Finally, the revenue impact of the Frenzel bill may represent a slightly overly-ambitious export incentive program. The Boren bill, S. 2708, eliminates some of these problems, but does not provide adequate incentive for the small or newly-formed exporting company. When one compares the current DISC provisions to the Boren bill, small or new exporters will generally experience substantial increases in effective tax rates under the proposed legislation.

In order to retain an incentive for the small or newly formed corporation, the dividend received deduction of the Boren bill should be structured on a graduated scale, which would, for example, allow all the Export Sales Corporations a larger dividend received deduction, and in effect, a lower tax rate on the first $1 million of revenues, declining through the second million of revenues, and leveling at a fixed percentage on all revenues thereafter.

Since small business accounts for less than 10 percent of all export revenue, we believe that a graduated dividend received deduction could be developed at little cost to the Treasury.

It is clear from these comments that some additional changes will be required in either bill. The proposed legislation does provide a framework. However, business and industry needs to be provided an opportunity for further comment and input during this formative period, so that any new vehicle designed in conformity with GATT will be as effective as DISC in stimulating U.S. exports.

Mr. Chairman, on behalf of NOIA, I appreciate the opportunity to present this statement, and I will be happy to answer any questions you might have. If any of the questions are more technical, or of a detailed tax nature, I have counsel, Mr. Kriss, from Diebold, Millonzi, Raiser & Robshaw of Buffalo and Washington, D.C.

Thank you.

[Mr. March's prepared statement follows:]

PREPARED STATEMENT OF FRANK A. MARCH, PRESIDENT, SEAWARD INTERNATIONAL, INC., ON BEHALF OF NATIONAL OCEAN INDUSTRIES ASSOCIATION

Mr. Chairman and Members of the Subcommittee, I am Frank A. March, president and chief executive officer of Seaward International, Inc., Falls Church, Virginia. Our company is engaged in the manufacture, development, and worldwide sales of marine fendering and flotation equipment.

I am appearing today on behalf of the National Ocean Industries Association (NOIA), where I serve as Vice Chairman of the Small Business Committee. NOIA is a national trade association with over 485 companies which serves as legislative spokesman for the nation's offshore and ocean-oriented industries. Approximately 40 percent of our membership consider themselves to be small business.

Our association is interested in export tax incentives since most of our membership is international in scope. As a result, export incentives are very important to our overall interests. I believe, however, that these comments are also widely applicable to many other industries and probably reflect the views of most small business exporters.

Export tax incentive programs, and particularly the Domestic International Sales Corporation (DISC) program are closely aligned to our general philosophy of government's optimum role in promoting exports. Government can best assist by providing tax incentives (as well as the regulatory, legal and reciprocal trade framework in which business can operate), but beyond that, business is capable of recognizing the incentives and maximizing them on their own. As a result the DISC has a much higher priority and interest for our members than government-sponsored information, counseling, or market analysis programs, government assistance in developing distributors, government-sponsored trade shows, or similar programs.

However, as we are all aware, the DISC is under increasing attack by the GATT Council as an illegal subsidy. It is clear that some form of alternative for the DISC must be developed to address export incentive needs while maintaining GATT compatibility. Therefore, this hearing occurs at a very timely point.

There are many reasons for the U.S. to look to exports to help our economic problems.

Job creation is a primary benefit of U.S. exports and an important reason for maintaining export tax incentives.

According to The Conference Board analysis reported in the August 11, 1982 Wall Street Journal, nearly 80 percent of all new manufacturing jobs created in the U.S. between 1977 and 1980 were linked to exports. The report said that a total of 4.7 million U.S. jobs were related to the export of manufactured products in 1980. With unemployment at 10.8 million Americans in August 1982, it is obvious that anything that produces 80 percent of the new U.S. manufacturing jobs is clearly something which should be encouraged and stimulated. In fact, a little simple arithmetic shows that we could cut the U.S. unemployment rate to 5.5 percent if we could double our exports.

Reduction of the U.S. trade deficit is a second important result of increased exports. The $27.8 billion trade deficit in 1981 and the merchandise trade deficit of $37.7 billion are staggering. These trade deficits have also contributed heavily to the recession. There is every indication that these deficit figures, as well as the impact of the recession, would have been even greater without the DISC or similar export tax incentives.

With the overvalued dollar, U.S. exporters face increasing competitive pressures from abroad. This greatly reduces or eliminates export profit margins and indeed in many cases, completely eliminates U.S. companies from a competitive position in the world marketplace. Certainly any diminution of export tax incentives would only exacerbate this situation.

Although it may at first seem unlikely, small business participation in exports is an important key to overcoming these problems.

The Senate Small Business report entitled, "Survey of Findings on Obstacles to Exporting Faced by Small Business" summarizes the small business export situation as follows:

"Of the U.S. businesses that do export, it is believed that roughly 80 percent of the total export market is controlled by only 200 firms. The Department of Commerce estimates that small business currently accounts for no more than 10 percent of total annual U.S. exports, but that at least 20,000 small firms in this country have the potential to competitively and profitably market their products overseas. Clearly, one of the greatest opportunities for reversing the 'no-growth' trend in our Nation's exporting lies with tapping that potential and increasing the number of small business exporters.

The report found that U.S. firms give the following reasons for not exporting: lack of information; regulations; expenses incurred; and financing.

When asked what role government should play in stimulating small business exports, the Number 1 response of U.S. firms was tax incentives, by almost a two-to-one margin over the next closest response. It is clear why tax incentives are the choice, since all the problems of lack of information, regulations, expenses incurred, and financing are overcome by sufficient financial incentives.

Let me give some examples of the types of problems small business exporters encounter today. These are typical of the problems faced by any exporter, but the initial market entry barriers seem proportionally higher to small businesses.

Market surveys and sales trips to develop an export market are enormously expensive today. It can easily cost $600 per day (for salary, travel and per diem expenses) to maintain a salesperson on a trip to a foreign market. When the number of trips required and the duration are considered, these costs add up very quickly to an astronomical level in the eyes of a small businessman. As a reference point, these costs are typically twice as much as for comparable U.S. sales.

This figure of "Twice as much for foreign versus domestic" is also fairly comparable for other expenses. Trade shows, advertising, foreign language literature, foreign patent filings, legal advice for foreign contracts, to name just a few, are typically double the U.S. cost.

Administering foreign contracts are also much more expensive than comparable U.S. contracts. Such costs as overseas telephone and telex; credit expenses such as letter or credit charges or foreign credit insurance; export shipping and documentation charges; and exchange rate variations are all additional cost factors which the sale to a U.S. customer does not usually require.

When the U.S. small businessman finally learns that many foreign customers take 90 days or more to pay, this is the "straw that breaks the camel's back." It's no wonder that more small businesses don't export!

Export tax incentives, of course, can help overcome some of these barriers. Our only real export tax incentive, the DISC, has helped many businesses increase their exports substantially. The DISC has the advantage of not requiring a large government bureacracy to administer since it relies solely on private sector initiatives. This allows the exporter flexibility in determining how to best allocate his resources. By having a DISC and the tax incentives it offers, many company managements develop a higher "export consciousness" and begin to spend more time, effort and resources on exports. The DISC also encourages businesses to manufacture in the U.S. rather than abroad or through licensing agreements. Finally, a DISC encourages increased exports since it permits taxes to be deferred, but only as long as they continue to be reinvested in the export business.

The experience of my own company, Seaward International, Inc., shows the benefits a DISC can produce. When we first established a DISC our exports were only 36 percent of our total sales. Today, exports constitute over 70 percent of our total sales. Our domestic sales have grown only 26 percent in this period while our export sales have grown 424 percent. Thus the value of export tax incentives!

I might add that the U.S. Treasury has not suffered at the expense of my company's export sales growth. Over the same period being considered our annual Federal tax liability went up over 600 percent.

This of course does not even include the additional personal income taxes or payroll taxes on the company's personnel, which have also grown substantially. Overall, not a bad return to the Treasury on a so-called "tax-break."

As I am sure someone else will testify, the report recently prepared by Price Waterhouse for several business groups indicated that because of "revenue feedbacks" the Treasury receives $1.24 in additional revenue for each dollar of DISC in terms of revenue foregone. If the experience of my company is any indication, this dollar-returned figure could be substantially higher, i.e., Treasury could be receiving a significantly greater revenue per dollar of DISC than the $1.24 indicated.

This would all suggest that the changes in DISC contained in the Tax Equity and Fiscal Responsibility Act of 1982 contain no more "tax equity" than they do "fiscal responsibility." The net effect of this Act is to cut the value of the DISC incentive by 15 percent for all tax years beginning after 1982. Due to reverse "revenue feedback" this will probably actually result in a decrease in revenue to the Treasury and an increase in the deficit, just the opposite of the desired result. Some tax increases, and the DISC is a good example, are pretty slippery.

This would all suggest, when we look at changes in export tax policy, that revenue raising should be far less of a consideration than job creation, reducing the trade deficit, and bringing the dollar back into balance on international markets. The revenue numbers will come around of their own accord when these other considerations have been addressed.

Obviously some changes in U.S. export tax incentives are required. Any new proposal will have to address the GATT objections to DISC. It will have to be a lasting and durable policy so that the mere uncertainty over its continued existence does not provide a disincentive for its use (as has been the case with DISC). It should be relatively simple and easy to administer (hopefully simpler than DISC). It should retain or amplify the provisions of DISC for small or newly established export companies, in order to continue the incentives for these companies to begin exporting.

I would like to now comment on several of the specific legislative proposals which address export tax policy.

Congress has recognized the need for changes in our export incentive programs and has introduced legislation which in one instance would offer a clear alternative to the DISC provisions and, in another, repeal these provisions in their entirety. The former bill (S. 2708) was introduced in July 1982 by Senator David Boren of Oklahoma and is based upon a territorial concept in conformity with the views of many of our trading partners. Without repealing the DISC provisions of the Code, the Boren bill would authorize American businesses to establish off-shore corporate subsidiaries called Export Sales Corporations ("ESC") through which such businesses could make export sales or perform export services pursuant to rules similar to those governing the organization and operation of DISC. A corporation desiring treatment as an ESC must be organized under the laws of a foreign country or possession of the United States other than the Commonwealth of Puerto Rico, and must maintain at least 95 percent of its gross receipts in the form of "qualified export assets." However, unlike the DISC provisions, the export incentives incorporated into the legislation are not based upon tax deferral, but rather, upon availability of a dividend deduction roughly equivalent to 32 percent of the profits of the ESC distributed or deemed distributed to its shareholders. It is anticipated by the proponents of this bill that, owing to the uncertainties associated with the use of DISC under GATT, businesses intending to enter export markets will take advantage of the ESC provisions and that DISC will, as a practical matter, become obsolete.

The Boren bill also contains a number of provisions designed to provide additional incentives for small or newly formed businesses. A credit of up to $5,000 is provided for administrative expense for one shareholder for managing an ESC on behalf of other shareholders. Subchapter S corporations may, under this proposed legislation, be a shareholder of an ESC, and the DISC requirement that the electing corporation have only one class of stock has been eliminated, thereby precluding the problem of disqualification on the basis of debt being construed as a second class of stock. These provisions provide flexibility and enhance the ability of small or newly formed corporations to commence export activities.

A similar attempt to alleviate the current problems with DISC is contained in H.R. 5179 which was introduced by Congressman William Frenzel of Minnesota late last year. This bill would repeal the DISC provisions after a one-year interim period and make available export incentives through the establishment of entities referred to as International Sales Corporations ("ISC"). This proposed legislation would permit the establishment of an off-shore subsidiary ISC which, similar to an ESC, would be organized under and pursuant to foreign law and would be subject to rules virtually identical to those presently governing the operation of DISC. The bill is designed to provide export trading incentives which are based upon a dividend received deduction in an amount equal to 100 percent of the profits of such corporation which are deemed distributed to its shareholders.

We believe that both the Boren and Frenzel bills represent legitimate attempts to establish an alternative export tax incentive program which will encourage American businesses to commence export activities. Nevertheless, both bills contain certain shortcomings which we believe require amendment in order to make export trade more attractive to domestic corporations.

For example, under the Frenzel bill, qualified export receipts do not include receipts from the sale, exchange, or disposition of export property to a "related" person. Since it is envisioned that the principal use of either an ISC or ESC would be to permit American corporations to sell export goods to foreign subsidiaries utilizing the favorable intercompany pricing rules similar to those which exist under DISC, this restriction serves no practical purpose and should be eliminated. In addition, an ISC may not have an office or fixed place of business in the United States. This requirement unnecessarily imposes additional organizational and administrative costs which inhibit use of the ISC vehicle by smaller American businesses. It is suggested that this requirement be dropped and, if this is not feasible in view of GATT, an exemption should be created for companies whose sales fall below a certain designated level. Assuming the DISC provisions are repealed, a five year phase-out rather than the one-year period envisioned in the Frenzel bill should be allowed in order to permit sufficient opportunity to educate potential exporters and devise workable regulations.

While the 100 percent dividend received deduction contained in the Frenzel bill may represent an overly ambitious export incentive program based on the revenue impact of the proposal, the 32 percent dividend received deduction contained in the Boren bill does not provide an adequate inducement for small or newly formed corporations to commence exporting activities. If one compares the application of the incremental rules of the present DISC provisions to the deduction concept embodied in the Boren bill, small or new exporters will generally experience an increase in effective tax rates under the proposed legislation. In order to retain an incentive for the small or newly formed corporation, the dividend received deduction should be structured on a graduated scale which would, for example, allow all Export Sales Corporations a larger dividend received deduction with respect to the first $1 million of revenues, declining through the second $1 million of revenues, and leveling at a fixed percentage on all revenues thereafter. Since 90 percent of all export revenues are generated by large corporations, it would appear that a graduated dividend received deduction could be developed to provide an added export incentive to the small or newly formed corporation at little cost to the government.

Although it is envisioned that substantial revision will be necessary with respect to both bills in order to create an export incentive program which is acceptable to the myriad of interests involved, the fact remains that time is of the essence. The proposed legislation does provide a framework for future discussions. It will, however, be necessary for business and industry to be provided an opportunity for comment and imput so that the new vehicle designed in conformity with GATT will be as effective as DISC in stimulating domestic export trade.

Mr. Chairman, on behalf of the National Ocean Industries Association, we appreciate the opportunity to present this statement. I will be happy to answer any questions you or the Subcommittee members might have.

Mr. NOWAK. Fine. Thank you very much.

A couple of examples you gave, specifically, about your own situation I think will be very helpful, showing what this can do combined with the right circumstances. I would take it your corporation had the right mixture of circumstances to use this incentive to create more employment in the United States. Do you have any job-related figures to the increase that you mentioned?

Mr. MARCH. I don't have those at my fingertips, but there has been a very substantial increase in employment as a result of the increased exports.

Mr. NOWAK. Does it relate generally to the increase in your gross exports?

Mr. MARCH. Yes, it does. As I mentioned, our domestic sales have grown only slightly in this 4-year period. Most of the sales growth has been as a result of inflation bumping the price of the products higher, with very little increase in the number of actual products shipped for the domestic side, but there has been a dramatic increase of exports, over five times the amount of exports that we had 4 years ago. That has been accompanied with an increase in jobs that is roughly proportional. So it has been a very substantial increase in employment as a result of having these incentives.

Mr. NOWAK. You have a reference to a graduated tax rate for the export income. Is there any reason this could not be a part of a territorial-type approach that has been discussed in the past?

Mr. MARCH. No, in fact, as I mentioned in my written testimony, the Boren bill, or either bill really, could have a graduated dividends received deduction. It would be relatively simple to incorporate that.

Mr. NOWAK. You had mentioned that you started this, I would take it, when you were relatively small in your 4- or 5-year-ago situation. It must have been somewhat of a gamble for you to go out and put together a subsidiary, and qualify for all the DISC regulations.

I wonder how much risk you took in terms of dollars, or in percentage of income, or whatever reference you can make, to that initial step to set DISC?

Mr. MARCH. Well, one of the points that I made was about the question of whether DISC would be continued. Even 4 years ago, we were worried about whether DISC would be continued, and I think as a result we waited even a couple of years longer than we could have had a DISC just to set it up. The costs were probably, the first year, primarily not the cost of legal advice and corporate advice, but the cost of internal personnel to be able to set this up and really get everyone familiar with it.

I would estimate that easily, the first year, the costs could have been 40 to 50 percent of our export earnings. Of course, that is a one-time cost, but the first year were very substantial costs.

Mr. NOWAK. It is claimed by some of our trading partners that the complexity is going to be a consideration in any drafting of a way around the illegality. Your suggestion here for a tax rate proposal perhaps could overcome some of those first gamble costs, to see if DISC will work for a specific corporation. Certainly, the incentive of reduced or graduated tax would, I believe, make some sense.

In the last tax bill we tried very desperately to reduce the corporate rates, and at least we were successful in moving on a couple of points. I think it is one of those things that will encourage people to participate. We hope to get more of the small- and medium-sized firms involved because of new incentives, and certainly more will probably go along with this proposal.

You know, it can't be a year-to-year markup, so to speak. With all the adjustments that would have to be made out there in the small business community, combined with the necessity for high legal fees, the trouble and cost may be prohibitive.

But let me ask Mr. Kriss if he has any feeling about the complexity issue and the cost issue to a small corporation which has some present objectives in going overseas. Perhaps, because of the uncertainty and complexity, they hesitate to do so. Are there enough incentives in the law now?

Mr. KRISS. Well, I think one thing has to be stressed. As Mr. March indicated, there was a heavy upfront load in terms of expense establishing the DISC. The further fact is that on an ongoing basis, internally, compliance with the DISC provisions requires a fairly substantial input from corporate staff as well as accountants.

I think the two proposals which are presently being discussed, the Boren and Frenzel bills, take a simplistic approach from the standpoint that each provides a dividend-received deduction. That, taken in conjunction with the suggestion that there be a tax credit for some amount—in one of the proposals, $5,000 was mentioned—to defray those startup costs, would be a significant incentive if you are talking about going to a foreign country to incorporate, and would probably be less expensive than trying to establish and operate a DISC under the present rules.

So I think that the proposal to provide an incentive in the form of a tax credit, and I don't think it has to be a significant one, is a step in the right direction to attempt to alleviate the cost considerations from the standpoint of small or newly established corporations.

In addition, assuming this could be done to satisfy the allegations that we are not in compliance with GATT, any legislation on this score, I believe should take the same conceptual approach that was taken under DISC, which represents a departure from the general analytical framework of substance over form.

Under the DISC provisions, it has been conceded that the DISC is merely a shell, with substantially all operations conducted through the parent corporation. I think that same approach could be taken under the proposals which are on the table in terms of merely requiring incorporation in a foreign jurisdiction, and having everything else done within this country through the parents. So I think all those concerns could be dealt with, very effectively, to reduce the costs under the proposed legislation below the costs of operating under the present system.

Mr. NOWAK. Thank you very much.

Mr. March, you have indicated that small or new exporters, would experience an increase, in fact, in the effective tax rate under the Boren bill. What type or what magnitude of increase are you talking about?

Mr. MARCH. Well—and this is prior to the 1982 tax bill taking effect, which starts after the end of this year—currently DISC income is taxed at an effective 23-percent tax rate for small or newly established DISC's.

The Boren proposal would increase this to 31 percent, which is the equivalent of the 32-percent dividends received deduction, and a 46-percent tax rate. This increase from 23 percent to 31 percent would represent a 36-percent increase in the effective tax rate for small business.

Mr. NOWAK. Mr. Marriott, do you have any questions, sir?

Mr. MARRIOTT. No, I apologize for being late, Mr. Chairman.

Mr. NOWAK. I might just mention your statement was read into the record.

Mr. MARRIOTT. Good. I have been a fan of DISC's for a long time. Anything we can do to improve on them, you would have my full support. So, I appreciate your testimony, and apologize for not being here to hear it all, but I will read it.

Mr. NOWAK. As we bring all this testimony together, Dan and I will sit down with all of this and digest the various points of view and hopefully, they will have some impact as this moves through the Congress and into the international arena. But we appreciate your testimony, because it does give us a few more specifics in an actual case where DISC had a very beneficial impact on all of the things you talked about: jobs, your own profitability, and bringing the competitive posture of your trade to the world. So, once again, we are going to leave the record open, and we may be back to you for more specifics.

Thank you very much.

Mr. MARCH. Thank you, Mr. Chairman.

Mr. NOWAK. Thank you, Mr. Kriss. Thank you, Mr. March.

We are going to have a short recess for about 10 to 12 minutes. Mr. Kriss, may I see you before you leave? We will be back with the testimony of the Price Waterhouse people. They are scheduled to testify this afternoon, but have consented to come in this morning, as the International Trade Administration had to postpone their testimony. Hopefully, it will be a temporary postponement, as they look at the whole area and try to develop some type of suggestions and recommendations for our consideration in the near future.

Mr. William Morris who is Assistant Secretary for Trade Development of the Commerce Department, could not be here today, but we certainly look forward to cooperating with them as they handle this whole question and try to resolve some of the complexities, find a way to bring this into GATT legality, and also provide something to balance off the other numerous incentives that other countries are using to export from their arena into the United States.

Then in the afternoon we will resume after 2 p.m. with panels 2 and 3. So we will just take a recess for about 10 minutes. Thank you.

[A short recess was taken.]

Mr. Nowak. Now, we have the Price Waterhouse testimony. John Korbel is the senior manager with the international accounting firm of Price Waterhouse. Mr. Korbel is director of the firm's Economic and Regulatory Service Group in Washington, D.C. I understand that Mr. Korbel will be accompanied by Bernard Shapiro, who is a former staff director to the Joint Tax Committee, and currently a Price Waterhouse partner serving as the firm's national director of tax policy; and Dr. Abram Hoffman, who is a senior manager with Price Waterhouse.

Gentlemen, welcome, and we are interested in hearing about your economic study.

TESTIMONY OF JOHN KORBEL, SENIOR MANAGER, PRICE WATERHOUSE, ACCOMPANIED BY BERNARD M. SHAPIRO, NATIONAL DIRECTOR OF TAX POLICY, AND ABRAM E. HOFFMAN, SENIOR MANAGER, ECONOMIC AND REGULATORY SERVICES

Mr. Korbel. Thank you, Mr. Chairman.

I am pleased to be here today to appear before this subcommittee to discuss the economic impacts of the domestic international sales corporation tax incentive.

Our ERS staff at Price Waterhouse recently completed a study entitled "Economic Impacts of the Domestic International Sales Corporation (DISC) Tax Provisions," for a group of private-sector clients.

Our study reviews the economic impacts of DISC by assessing costs and benefits, and considering what would happen if DISC were repealed. DISC was enacted in 1971 to stimulate U.S. exports, and thereby improve our balance of trade. By providing tax deferral on a portion of net income earned from exports, DISC's goal was to enhance the ability of U.S. firms to compete abroad. Many experts recognize that DISC redresses the imbalances in tax treatment between U.S. exporters and those in other countries.

While DISC may not be costless, it is also not without its benefits. U.S. Treasury calculations for 1979 suggest that the initial cost of DISC is $1 billion in foregone tax revenues on the income deferred through DISC. When some of the major feedbacks caused by the DISC-induced exports are considered, however, net Treasury tax collections may actually increase. A certain amount of exports will occur with and without the DISC incentive. The portion of exports that would not occur in the absence of DISC are referred to as DISC-induced exports. Thus, the American taxpayer may be better off with DISC than without it.

The purpose of my testimony today is to summarize our findings on the economic impacts of DISC contained in the above-referenced report. Today I would like to present my prepared statement in its entirety and request that it and the Price Waterhouse report on DISC be included in the record of this proceeding.

Mr. **Nowak**. Without objection, it is so ordered.

Mr. **Korbel**. Thank you, Mr. Chairman.

Our DISC study was prepared at the request of several organizations representing U.S. trade interests. Sponsoring organizations included the U.S. Chamber of Commerce, the Business Roundtable, the National Association of Manufacturers, the Emergency Committee for American Trade, the Special Committee for U.S. Exports, the National Foreign Trade Council, and the American Business Conference. These organizations and the business community were challenged by Treasury officials to demonstrate the cost-effectiveness of DISC and were asked to prepare a report that quantifies the costs and benefits of DISC.

Price Waterhouse was asked in mid-March to undertake this cost-effectiveness investigation of DISC. Of necessity, this analysis was preliminary and "broad-brushed," given the Treasury Department's desire to complete the report within 1 month, by April 15, and thereby avoid premature decisions regarding repeal or modifications of DISC.

Treasury revenue loss estimates, and methods for calculating the export impacts of DISC served as the starting point of our analysis. All figures were based on the Treasury's annual report on the operations, and effects of DISC for DISC year 1979. This information came from, "The Operation and Effect of the Domestic International Sales Corporation Legislation, 1979 Annual Report," U.S. Department of the Treasury, April 1981. The economic impacts were considered with and without the accelerated cost recovery system—ACRS—enacted in the Economic Recovery Tax Act of 1981.

Through a critique of the Treasury methods and estimates, the study sought to answer the following questions:

What is the true initial revenue loss associated with DISC?

What is the range of possible impacts of DISC on U.S. exports?

What are the tax revenue implications of the DISC-induced U.S. exports?

What are the net cost implications of DISC and, conversely, of repealing DISC?

We used a partial feedback approach to answer the above questions. Partial feedbacks may occur when additional Government revenues and outlays are generated by DISC-induced exports. Thus, as I indicated in our analysis, U.S. Treasury revenue loss estimates served as the starting point in assessing the costs and benefits of DISC. Specifically, utilizing Treasury's own method for estimating DISC-induced exports, we developed a range of market responses to DISC and our partial feedback analysis considered: First, Government revenue losses that would occur in the absence of DISC; and second, the feedback effects of DISC-induced exports on Federal corporate income, personal income, and payroll tax collections.

Our feedback analysis considered only the major initial feedbacks on the Treasury, and did not consider potential feedbacks from subsequent rounds of economic activity. For example, DISC will also impact State and local revenue collections, as well as Government outlays for transfer payments, such as welfare and unemployment compensation.

The partial feedback analysis performed by Price Waterhouse may be summarized as follows: Treasury estimates that the revenue loss associated with DISC sales of $99.6 billion was $994 million in DISC year 1979. This estimate of revenue loss includes taxes deferred on DISC-induced exports, that is exports that would not occur in the absence of DISC. Based upon our estimated range for DISC-induced exports discussed below, DISC sales would have ranged between $92.6 and $98.1 billion in the absence of DISC. The "true" initial revenue loss associated with DISC ranges between $779 and $970 million in 1979. The remainder, as compared to the Treasury estimate of $994 million, represents taxes deferred on exports that would not have existed in the absence of DISC.

A stated purpose of DISC is to stimulate U.S. exports. By reducing the costs to U.S. exporters via the tax mechanism, DISC improves the ability of U.S. firms to compete in the world market. Treasury estimates the export impact of DISC by assuming that exporters pass the benefits of the tax incentive on to consumers. Given uncertainty regarding price responsiveness in the U.S. export market, Treasury estimates that DISC will induce an increase in the value of U.S. exports between $4.5 to $7 billion. Empirical evidence on price responsiveness is inadequate for accurately providing a point estimate and Price Waterhouse has expanded the range of uncertainty to include lower price responsiveness assumptions than Treasury. Overall, Price Waterhouse estimates that DISC will induce additional exports valued between $1.5 to $7 billion. Our moderate price responsiveness case suggests DISC-induced exports of $5.3 billion in 1979.

The DISC-induced exports will generate additional Treasury revenues. Assuming that resources used in the production of DISC-induced exports were previously unemployed—a plausible assumption in today's economy—and that the DISC-stimulated exports represent a net increase in the U.S. balance of trade, DISC will add to the aggregate output of the U.S. economy and U.S. tax collections. For example, based on the moderate price response case, that is, $5.3 billion induced exports, Treasury will realize the following changes in several major Federal taxes: Corporate income taxes will increase by $161 million; personal income taxes will increase by $451 million; and payroll taxes will increase by $420 million. Thus, from the corporate income, personal income, and payroll taxes alone, DISC would add about $1 billion to the U.S. Treasury collections.

As suggested earlier, changes in these three major taxes are not the only benefits of DISC. Increases in economic activity reduce many Government outlays, such as welfare and unemployment compensation, and also augment State and local tax collections. Moreover, the quantified feedbacks represent those that occur in the initial round. Indeed, when the "ripple effects" through the economy are considered, these revenue benefits of DISC may be more than doubled.

When the initial revenue loss is compared to the additional tax collections generated by the DISC-induced exports, the DISC net subsidy is significantly reduced, and, under certain assumptions, Treasury is better off with DISC than without it. Based on the export impacts described above, the ratio of additional revenues from feedbacks—that is, benefits to the initial revenue losses—that is, costs—range from 0.29 to 1.76. The moderate price response case suggests a ratio of 1.24. In other words, for every dollar spent on DISC in terms of revenues foregone, the Treasury receives $1.24 in additional revenue collections. Thus, by eliminating DISC, Treasury revenues would decline by $199 million.

According to Treasury, the effect of the accelerated cost recovery system [ACRS] on DISC—established under the Economic Recovery Tax Act of 1981—is to reduce both the revenue losses and export impacts by the same percentage or approximately 27 percent. Thus, had ACRS been fully implemented in DISC year 1979, elimination of DISC would still cost the Treasury $146 million.

Thus, we conclude that the DISC provisions increase U.S. export sales by between $1.5 and $7 billion at little or no cost to the Treasury. In fact, under a reasonable set of assumptions, DISC may actually increase both output and total Treasury receipts at a time of low capacity utilization and high unemployment in the U.S. economy. This finding remains true when the effects of ACRS are considered.

Our study should be considered suggestive rather than predictive, however, since it is based upon a partial feedback analysis. This partial feedback analysis required simplifying assumptions for purposes of quantification and did not quantify numerous other feedbacks that may augment or diminish the final result.

Thank you for the opportunity to testify before this subcommittee. We would be glad to answer any questions you may have.

[The report referred to above follows:]

ECONOMIC IMPACTS OF THE DOMESTIC INTERNATIONAL SALES CORPORATION (DISC) TAX PROVISIONS

A Study Prepared for

The American Business Conference
The Business Roundtable
The Emergency Committee for
American Trade
The National Association
of Manufacturers
The National Foreign Trade Council
The Special Committee for U.S. Exports
The U.S. Chamber of Commerce

April 15, 1982

Prepared by

Price Waterhouse
Economic and Regulatory Services
1801 K Street, N.W.
Washington, D.C. 20006
(202) 296-0800

Price Waterhouse

April 15, 1982

Mr. R. T. McNamar
Deputy Secretary
Department of the Treasury
Washington, D.C.

Dear Mr. McNamar:

The undersigned business organizations and their members believe that the DISC program provides valuable assistance to U.S. exporters and enhances the international competitiveness of the United States.

In our meeting with you earlier this year, you asked for data in support of our contention that DISC provides a cost effective export incentive. The Price Waterhouse study transmitted herewith makes it amply clear that Treasury receives significant new revenue as a result of DISC, possibly enough to make the overall cost of DISC negative. The middle range of the estimates calculated by Price Waterhouse suggest that, "For every dollar spent on DISC in terms of revenues foregone, the Treasury receives $1.24 in additional revenue collections." We have discussed these findings with Under Secretary Ture and have provided him with a copy of the Price Waterhouse report.

The study is largely confined to the revenue effect of DISC, an area of special interest to the Treasury. There are, however, additional compelling arguments in support of DISC.

The legislative history to the Revenue Act of 1971 explains that an export incentive like DISC is necessary to off-set the tax advantages inherent in the tax structures of many of our trading partners. In this connection the legislators referred both to territorial tax provisions, which limit corporate activities subject to tax to those carried out within the borders of the taxing country, and to multistage sales taxes or value added taxes. In other words, DISC is designed to remove a disincentive to exporting that is a peculiar feature of U.S. tax law.

In discussing DISC as a tax incentive, it is important to be clear that it is not a subsidy. Ambassador David MacDonald explained the outcome of the GATT action affecting DISC in a memorandum to the Private Sector of December 8, 1981. It is useful to quote briefly from that memorandum:

> "At the December 8, 1981, GATT Council meeting the GATT Panel reports on DISC and the related tax practices of France, Belgium, and the Netherlands were adopted by the GATT Council with a qualification which reflects acceptance by these countries and the EC of the principle that an exporting country need not tax economic activities involving exported goods located outside its territorial boundaries. It is our view that the U.S. global system of taxing export sales, inclusive of the DISC provisions, is consistent with this principle...."

Obviously, if there is no obligation to tax, there can be no subsidy either through the failure to tax or through tax deferral. Ambassador Brock recently delineated the practical ramifications of this principle in a letter to Chairman Gibbons of the House Ways and Means Subcommittee on Trade. "Because the U.S. method of taxing exports results in a level of taxation above the level invoked in a territorial system," Ambassador Brock wrote, "we believe that the U.S. is under no obligation to modify or repeal the DISC."

The strength of the Price Waterhouse report is solid economic analysis, analysis that should put to rest the idea that DISC is not cost effective. A discussion of the role DISC plays in the life of the more than 7,000 companies that utilize DISC provisions is, however, beyond the scope of the report. It is nevertheless very relevant to an appreciation of the importance of DISC. If you wished to have them, we would be pleased to submit to you comments from individual companies on the value of DISC to their operations. A facet of DISC illuminated by such comments is that it has helped firms to appreciate better the value to them of the export market and to plan accordingly, specifically by allocating investment and marketing resources for exports. By making the foreign market a separate profit center, DISC has made it more visible to financial managers.

Increased exports can help the United States recover from recessions like the present one. That point is well documented in the Price Waterhouse study. It should be obvious, though, that the value of exports and the value of DISC are independent of business cycles. We need exports, that is we need to be competitive, in good times as well as bad.

We have given thought, as you have asked us to do, to other tax and non-tax incentives to exports, bearing in mind both cost effectiveness and compatibility with the GATT. We have concluded that from a pragmatic standpoint there is no suitable substitute for the DISC. If the times were propitious to consider improvements, we would suggest repeal of the 1975 amendments to DISC. These, as you will recall, have had the effect of reducing by half the value of DISC to exporters.

We conclude with a comment that is made by virtually every businessman who has considered the problem of export incentives. It is the bottom line that motivates business to invest more. The objective is to make exports as profitable as possible. The Treasury analysis of DISC's effectiveness is a marginal price analysis and appropriately, therefore, so is the Price Waterhouse study. Increasing taxes on exports, as the elimination of DISC obviously would, is the surest way to reorder business priorities to the disadvantage of exports. In the real world, prices are not likely to be raised on exports if DISC is eliminated. The risk rather is of the loss of management's long term commitment to exporting. U.S. international competitiveness and U.S. industrial strength would surely suffer as a result.

Very truly yours,

John M. Albertine
American Business Conference

H Richard Kobl
Business Roundtable

Chamber of Commerce of the United States

Emergency Committee for American Trade

National Association of Manufacturers

National Foreign Trade Council

Special Committee for U.S. Exports

TABLE OF CONTENTS

Page

EXECUTIVE SUMMARY vii

I. INTRODUCTION AND SUMMARY 1

A. Background on the Report 1

B. Summary of Findings 3

C. Outline of the Report 5

II. BACKGROUND ON DISC 7

A. DISC Provisions and Changes 7

B. The Economic Recovery Tax Act of 1981 10

III. THE EXPORT IMPACT OF DISC 14

A. Measuring Changes in U.S. Exports The U.S. Treasury Method 14

B. Elasticity Assumptions 17

C. Results of the Scenarios 25

IV. THE COSTS AND BENEFITS OF DISC 28

A. Methods of Measuring the Net Costs of DISC 29

B. Treasury Estimates of DISC Costs 32

C. A Quantitative Example of Net Costs 41

TABLE OF CONTENTS

Page

V. SOME ECONOMIC IMPACTS OF DISC IN A GENERAL EQUILIBRIUM FRAMEWORK 49

- A. The Effects of DISC on the Balance of Payments 50
- B. The Effects of DISC on the Net Output of the U.S. Economy 56

VI. THE EFFECTS OF ELIMINATING DISC 62

- A. Cost/Benefit Assessment 62
- B. Repeal of DISC with ACRS 64
- C. Conclusions 66

LIST OF TABLES

Table		Page
II-1.	Effective Tax Rates Under Alternative Tax Systems	12
II-2.	Before Tax Rate of Return Required to Obtain an After Tax Rate of Return of 15 Percent Under Alternative Tax Systems	13
III-1.	Elasticities of Supply and Demand Assumed by U.S. Treasury in 1979 Annual Report	19
III-2.	U.S. Export Supply Elasticities Cited in the Literature	21
III-3.	U.S. Export Demand Elasticities Cited in the Literature	22
III-4.	Elasticities of Supply and Demand for Low, Moderate, and High Scenarios	24
III-5.	Induced Exports--Low, Moderate, and High Response Scenarios	26
IV-1.	Net Cost of DISC Based Upon Partial Feedback of Revenues from Induced Exports Assuming a Marginal Profit Rate of 6.4 Percent, DISC Year 1979	43
IV-2.	Net Cost of DISC Based Upon Partial Feedback of Revenues from Induced Exports Assuming a Marginal Profit Rate of 12.8 Percent, DISC Year 1979	44

LIST OF FIGURES

Figure Page

IV-1. Market for U.S. Exports with DISC 35

IV-2. Market for U.S. Exports With and Without DISC 37

Price Waterhouse

EXECUTIVE SUMMARY

The purpose of the Domestic International Sales Corporation (DISC) tax provisions is to enhance the ability of U.S. firms to compete in the world marketplace. The two primary effects of DISC are to:

- Increase export sales by the U.S., and
- Decrease tax receipts from export sales that would have occurred in the absence of DISC.

The U.S. Treasury, in its 1979 DISC Annual Report, estimates the magnitudes of these effects as follows:

- $4.5 to $7.0 billion in DISC-induced export sales, and
- $994 million in reduced tax revenues.

The purpose of the study performed by Price Waterhouse is to examine the economic impacts of DISC, in particular the estimated magnitudes of DISC-induced export sales, and the cost of DISC to the U.S. Treasury.

In brief, our findings are:

- Treasury estimates understate the likely range of values for DISC-induced export sales. Our analysis suggests a range of $1.5 to $7.0 billion, with a moderate response estimate of $5.3 billion.
- Treasury estimates of DISC costs include foregone corporate taxes on both existing and DISC-induced export sales. Since the true cost of DISC is the amount of taxes foregone on existing export sales, the Treasury estimate of the cost of DISC ($994 million) should be reduced by $161 million under a moderate response scenario (to $833 million).

Assuming a moderate response estimate of $5.3 billion in DISC-induced exports, and current slack conditions in the U.S. economy, the following effects are observed:

- $161 million increase in corporate income taxes;
- $451 million increase in personal income taxes; and
- $420 million increase in payroll taxes.

In summary, we conclude that the Treasury estimate of DISC costs of $994 million should be reduced to $833 million and should be further reduced by the following DISC-induced tax collections:

	Revenue Feedbacks ($ in millions)
Corporate Income Taxes	$161
Personal Income Taxes	451
Payroll Taxes	420
Total	$1,032

In other words, rather than costing the taxpayer, DISC actually returns $1.24 to the Treasury for each dollar of tax incentive provided.

Thus, we conclude that the DISC provisions increase U.S. export sales by between $1.5 and 7.0 billion at little or no cost to the Treasury. In fact, under a reasonable set of assumptions, DISC may actually increase both output and total Treasury receipts at a time of low capacity utilization and high unemployment in the U.S. economy.

1. INTRODUCTION AND SUMMARY

This report reviews the economic impacts of the Domestic International Sales Corporation (DISC) tax provisions by assessing their costs and benefits and considering what would happen if DISC were repealed. DISC was enacted in 1971 to stimulate U.S. exports and, thereby, improve our balance of trade. By providing tax deferral on a portion of net income earned from exports, DISC's goal is to enhance the ability of U.S. firms to compete abroad. Many experts recognize that DISC redresses imbalances in tax treatment between U.S. exporters and those in other countries.

While DISC may not be costless, it is also not without its benefits. U.S. Treasury calculations for 1979 suggest that the initial cost of DISC is $1 billion in foregone tax revenues on the income deferred through DISC. When some of the major feedbacks caused by the DISC-induced exports are considered, however, net Treasury tax collections may actually increase.[1] Thus, the American taxpayer may be better off with DISC than without it.

A. Background on the Report

This report has been prepared at the request of several organizations representing U.S. trade interests. Sponsoring organizations include the U.S. Chamber of Commerce; the Business Roundtable; the National Association of Manufacturers; the Emergency Committee for American Trade; the Special Committee for

---

[1] A certain amount of exports will occur with and without the DISC incentive. The portion of exports that would not occur in the absence of DISC are referred to as DISC-induced exports.

U.S. Exports; the National Foreign Trade Council; and the American Business Conference. These organizations and the business community have been challenged by Treasury officials to demonstrate the cost-effectiveness of DISC and were asked to prepare a report that quantifies the costs and benefits of DISC. This report was to be completed and transmitted to Treasury by April 15.

Price Waterhouse was asked in mid-March to undertake this cost-effectiveness investigation of DISC. Of necessity, this analysis is preliminary and "broad brushed," given the desire to complete the report by April 15 and avoid premature decisions regarding repeal or modification of DISC. Treasury revenue loss estimates and methods for calculating the export impacts of DISC served as the starting point of the analysis. All figures are based on the Treasury's annual report on the operations and effects of DISC for DISC year 1979.[2] The economic impacts are considered with and without the Accelerated Cost Recovery System (ACRS) enacted in the Economic Recovery Tax Act of 1981.

Through critiquing the Treasury methods and estimates, the study seeks to answer the following questions:

- What is the "true" initial revenue loss associated with DISC?
- What is the range of possible impacts of DISC on U.S. exports?

---

[2] See "The Operation and Effect of the Domestic International Sales Corporation Legislation, 1979 Annual Report," U.S. Department of the Treasury, April 1981.

- What are the tax revenue implications of the DISC-induced U.S. exports?
- What are the net cost implications of DISC and, conversely, of repealing DISC?

B. Summary of Findings

The partial feedback analysis performed by Price Waterhouse provides the following answers to the above questions.

True Initial Revenue Loss. Treasury estimates that the revenue loss associated with DISC sales of $99.6 billion was $994 million in DISC year 1979. This estimate of revenue loss includes taxes deferred on DISC-induced exports (that is, exports that would not occur in the absence of DISC). Based upon our estimated range for DISC-induced exports discussed below, DISC sales would have ranged between $92.6 and $98.1 billion in the absence of DISC. The "true" initial revenue loss associated with DISC ranges between $779 and $970 million in 1979. The remainder (as compared to the Treasury estimate of $994 million) represents taxes deferred on exports that would not have existed in the absence of DISC.

Impact on Exports. A stated purpose of DISC is to stimulate U.S. exports. By reducing the costs to U.S. exporters via the tax mechanism, DISC improves the ability of U.S. firms to compete in the world market. Treasury estimates the export impact of DISC by assuming that exporters pass the benefits of the tax incentive on to consumers. Given uncertainty regarding price responsiveness in the U.S. export market, Treasury estimates that DISC will induce an increase in the value of U.S. exports of between $4.5 and $7.0 billion. Empirical evidence on price responsiveness is inadequate for accurately providing a point estimate and Price Waterhouse has expanded the range of uncertainty to include lower price responsiveness assumptions than Treasury. Overall, Price Waterhouse estimates that DISC will induce additional exports valued between $1.5 and $7.0 billion. Our moderate price responsiveness case suggests DISC induced exports of $5.3 billion in 1979.

Revenue Feedbacks. The DISC-induced exports will generate additional Treasury revenues. Assuming that resources used in the production of DISC-induced exports were previously unemployed--a plausible assumption in today's economy--and the DISC stimulated exports represent a net increase in the U.S. balance of trade, DISC will add to the aggregate output of the U.S. economy and U.S. tax collections. For example, based on the moderate price response case ($5.3 billion induced exports), Treasury will realize the following changes in several major Federal taxes:

	Revenue Feedbacks ($ in millions)
Corporate Income Taxes	$ 161
Personal Income Taxes	451
Payroll Taxes	420
Total	$1,032

From the corporate income, personal income, and payroll taxes alone, DISC would add $1,032 million to the U.S. treasuries.

Changes in these three major taxes are not the only benefits of DISC. Increases in economic activity reduce many government outlays such as welfare and unemployment compensation and also

Price Waterhouse

augment state and local tax collections. Moreover, the quantified feedbacks represent those that occur in the initial round. Indeed, when the "ripple effects" through the economy are considered, these revenue benefits of DISC may be more than doubled.

Net Costs of DISC. When the initial revenue loss is compared to the additional tax collections generated by the DISC-induced exports, the DISC net subsidy is significantly reduced and, under certain assumptions, Treasury is better off with DISC than without it. Based on the export impacts described above, the ratio of additional revenues from feedbacks (benefits) to initial revenue loss (costs) range from .29 to 1.76. The moderate price response case suggests a ratio of 1.24. In other words, for every dollar spent on DISC in terms of revenues foregone, the Treasury receives $1.24 in additional revenue collections. Thus, by eliminating DISC, Treasury revenues would decline by $199 million.

According to Treasury, the effect of the Accelerated Cost Recovery System (ACRS)[3] on DISC is to reduce both revenue losses and export impacts by the same percentage or approximately 27 percent. Thus, had ACRS been fully implemented in DISC year 1979, elimination of DISC would still cost the Treasury $146 million.

C. Outline of the Report

The rest of this report reviews in more detail the costs and benefits of DISC and is organized as follows:

---

[3] Established under the Economic Recovery Tax Act of 1981.

- Section II--Background on DISC. This section describes the DISC tax provisions and how they have changed over the decade. Particular attention is given to the relationship between DISC and ACRS.

- Section III--The Export Impact of DISC. This section identifies changes in U.S. exports as a major source of the benefits derived from DISC. Using the Treasury method, export impact estimates are provided under several price responsiveness assumptions.

- Section IV--The Costs and Benefits of DISC. In this section, a partial feedback analysis is performed to assess the net cost implications of DISC. The section begins with a discussion of the advantages and disadvantages of various methods for tax incentive analysis. In this context, the Treasury revenue loss estimates are critiqued. Finally, using the Treasury initial revenue loss figures, a partial feedback analysis is performed.

- Section V--Some Economic Impacts of DISC in a General Equilibrium Framework. In this section, the implication for DISC impacts in a more general framework are considered. Specifically, this section discusses two issues: First, the potential impact of DISC on the balance of trade through changes in the exchange rate; and second, changes in economic efficiency that may result when resources used in the production of DISC exports have been diverted from elsewhere in the U.S. economy.

- Section VI--The Effects of Eliminating DISC. This section reviews the costs and benefits of DISC and summarizes the revenue implications of repealing the DISC provisions. These revenue implications are considered before and after the full implementation of ACRS.

II. BACKGROUND ON DISC

This section discusses the manner in which the DISC provisions provide an incentive to earn export income. The section is arranged in two subsections:

- DISC Provisions and Changes
- The Economic Recovery Tax Act of 1981

The first subsection describes the tax benefits of DISC and reviews the evolution of the program. The second subsection explains briefly the effect of recent tax changes--which do not directly change the DISC program--on the costs and benefits of DISC.

A. DISC Provisions and Changes

In 1971, the United States was faced with its largest balance of payments deficit in history. In response to this crisis, a series of steps were taken. First, official gold sales were halted and the dollar was devalued against foreign currencies. Second, a temporary tariff or surcharge was instituted on imported commodities. Third, the Domestic International Sales Corporation (DISC) program was enacted, effective for 1972. DISC created a tax incentive to earn export income, thus encouraging U.S. corporations to enter and expand their positions in the export market. The program was designed not only to encourage sales to foreign consumers but, more importantly, to encourage U.S.-based production.

The DISC incentive was created by the Revenue Act of 1971. Taxpayers are permitted to establish corporations (called Domestic International Sales Corporations) to conduct their export activities. Under the Act, the DISC legislation provides deferral of federal income tax on 50 percent of the export earnings allocated to the DISC, with the balance treated as dividend to the parent company. (The portion of the export income allocated to the parent company is taxed in the normal manner.) To qualify for the tax deferral, a DISC must meet several criteria including:

1. The DISC must be incorporated in the United States and have no more than one class of stock, and par or stated value of the stock must be at least $2,500 each day of the taxable year.
2. The DISC must obtain 95 percent or more of its receipts from "qualified exports receipts."[4]

---

[4] In general, qualified receipts are generated from the sale or lease of "export property" (defined in footnote 5 below) or commissions from these export transactions. Other qualified receipts include interest income from a qualified export asset, service income "related and subsidiary" to the sale or lease of export property and service income from engineering or architecture services with respect to foreign construction projects.

3. At least 95 percent of the DISC's assets must be "qualified export assets."[5]

As noted, DISC must distribute, or be treated as distributing, a portion of its export earnings to its shareholder(s) each year. The export income of a DISC, which arises from transactions with a related supplier, can be calculated in one of three ways:

1. Four percent of the receipts from the sale of export property plus ten percent of export promotion expenses;
2. Fifty percent of the combined taxable net export earnings of the DISC and related supplier plus ten percent of export promotion expenses, which can be applied on a marginal costing basis in certain circumstances; or
3. The net export earnings of the DISC based on the price actually charged if the price is based on an arm's-length transaction.

---

[5] Some common qualified assets include "export property," assets used primarily in connection with the sale or lease of export property, accounts receivable arising in connection with export transactions, so-called "producer loans," and money and temporary investments to the extent reasonably needed to meet working capital requirements.

"Export property" is defined as property manufactured, produced, grown or extracted in the United States by a person other than a DISC. Such property must be held primarily for sale, lease or rental by or to a DISC for direct use or consumption outside the United States. In addition, not more than 50 percent of the fair market value of the property can be attributable to articles imported into the United States.

The income so determined, plus any other income which a DISC may earn, is then subject to the required distribution (or deemed distribution) rules. The remainder of the income may be retained by the DISC as tax deferred income as long as the DISC qualifications are maintained.

The Tax Reduction Act of 1975 removed the tax deferral for export earnings attributed to the sale of products in short supply in the U.S. and also removed DISC benefits for earnings from certain natural resources. The Tax Reform Act of 1976 added an additional requirement that tax deferral benefits could be applied only to incremental sales. The incremental sales requirement is as follows: For taxable years beginning after December 31, 1975, deferral treatment is permitted only for income from export gross receipts exceeding 67 percent of average export gross receipts during a four-year base period. Accordingly, 100 percent of the income attributable to non-incremental exports is deemed distributed to the parent company, while 50 percent of the income attributable to incremental exports is deemed distributed. DISCs with income of $100,000 or less are not affected by this incremental provision. In addition, the 1976 Act reduced tax deferral attributable to sales of military goods.

B. The Economic Recovery Tax Act of 1981

The effect of DISC is to reduce the cost of capital used in producing export goods. The Economic Recovery Tax Act of 1981, however, by liberalizing depreciation allowances in calculating federal income tax liability, has reduced the effective tax rate and lowered the cost of capital for both the domestic and export sectors. Briefly, the Accelerated Cost Recovery System (ACRS) has replaced the Class Life Asset Depreciation Range (CLADR) system. By accelerating the depreciation of property, ACRS permits larger deductions in the initial years of an investment.

Permitting depreciation allowances to be claimed earlier in the life of the investment increases the net present value of an after-tax stream of returns. A higher net present value given a fixed cost of capital, increases the likelihood that an investment project will be undertaken. Alternatively, the effect of ACRS can be viewed as reducing the cost of capital relative to a fixed stream of returns.

Because ACRS is applied to all firms, regardless of the destination of their final products, the relative tax advantage of DISC has been diminished. DISC is a tax incentive valued at a fixed percentage of taxable income. As ACRS reduces taxable income, the DISC program is relatively less beneficial to exporters and relatively less costly to the Treasury.

To demonstrate the effect of ACRS on DISC, one study calculated the effective tax rate for a typical, although hypothetical, manufacture-for-export project.[6] These results are shown in Table II-1.

---

[6] Thomas Horst, "The Impact of DISC, ACRS, and the Proposed FISC Rules on the Effective Tax Rate for Export Income," Tax Notes, November 16, 1981.

Table II-1

EFFECTIVE TAX RATES UNDER ALTERNATIVE TAX SYSTEM [7]

	CLADR Rules	ACRS Rules
Without DISC	28.3%	24.3%
With DISC	20.8%	17.6%

These tax rates significantly affect firms' decisions to invest. Assume that a firm requires an after-tax return of 15 percent to undertake an investment. Using the study's calculations, the 15 percent after-tax return requires the before-tax rates of return illustrated in Table II-2.

---

7. Horst defines the effective tax rate as the percentage reduction in the internal rate of return of the project due to taxes.

Table II-2

BEFORE TAX RATE OF RETURN REQUIRED TO OBTAIN AN AFTER TAX RATE OF RETURN OF 15 PERCENT UNDER ALTERNATIVE TAX SYSTEMS

	CLADR Rules	ACRS Rules
Without DISC	20.92%	19.81%
With DISC	18.94%	18.20%

Two important points are apparent from Table II-2. First, this typical exporter is better off with DISC and without ACRS than with ACRS and without DISC. Second, ACRS provides greater benefits to firms without DISC (such as firms that produce for domestic consumption) than it provides to firms with DISC. This advantage is apparent both in absolute and in relative terms.

Under the ACRS system, we conclude that DISC will lose some of its effectiveness in promoting export production relative to production for domestic use. However, the cost of DISC to the Treasury will also decline.

III. THE EXPORT IMPACT OF DISC

The purpose of the DISC provisions is "to increase our exports and improve our balance of payments."[8] Besides inducing an increase in exports, other benefits can also be ascribed to DISC. These potential benefits include increases in corporate earnings (and the taxes thereon) from the induced exports, increases in personal income through job creation, increases in the economic growth rate, and reductions in unemployment compensation and other transfer payments.

In order to estimate any of these possible benefits, however, the initial impact of DISC on increasing U.S. exports must first be determined. In this section, we evaluate the method used by the Treasury to estimate the impact of DISC on U.S. exports for DISC year 1979 (as reported in the 1979 Annual Report on DISC released by Treasury in April 1981). Based on our analysis of the demand and supply elasticities available from Treasury and other sources, we propose a range of likely outcomes for the level of exports induced by the DISC tax provisions. In Section IV, these results are used to develop measures of cost-effectiveness for DISC.

A. Measuring Changes in U.S. Exports--The U.S. Treasury Method

The U.S. Treasury was charged by Congress with the annual production of a report that analyzes the effect of the DISC provisions. These annual reports, starting with 1972 and most recently for 1979, have attempted to quantify the increase in exports attributable to DISC. For DISC year 1979, the Treasury estimates that DISC accounted for between $4.5 and $7.0 billion in increased U.S. exports at a cost to the Treasury of nearly $1.0 billion in reduced receipts from corporate income taxes.

---

[8] H.R. Rep. No. 533, 92nd Cong., 1st Sess. 1 (1971); S. Rep. No. 437, 92nd Cong., 1st Sess. 1 (1971).

In earlier annual reports, the Treasury attempted to infer the level of DISC-induced exports by comparing the growth of DISC and non-DISC exports. In an era that included rapid increases in both U.S. exports and world trade, high inflation rates, and floating and sometimes volatile exchange rates, the attribution of differential growth rates for exports in these two categories to the DISC provisions alone is questionable. In addition, problems concerning the derivation of DISC and non-DISC export volumes resulted in a high sensitivity of these estimates to errors in the trade data.

Recognizing these difficulties, the Treasury implemented two changes in estimating DISC-induced exports in the 1979 Annual Report. The first change was in the method employed. The new method is basically a supply-demand analysis for four broad categories of exports that relies critically on estimates of the supply and demand elasticities for each category. The second change is the recognition of the uncertainty involved in estimating elasticities, and hence in the ultimate export estimates. The Treasury now provides a range of export estimates to reflect the uncertainty in the assumed elasticity values.

Through the mechanism of increasing the after-tax profitability of exports, DISC induces an increase in the amount of exports that producers will supply at a specific price. This shift in the export supply schedule, combined with both demand and supply responses, generally results in a higher quantity of exports sold, a somewhat lower price for those exports, and higher values for both the total value of exports and export profits. The magnitude of these changes depends on the degree of shift in supply schedules and responsiveness of both supply and demand to changes in price, as summarized by supply and demand elasticities with respect to price.[9]

The change in total export revenue associated with a tax benefit of X dollars is given by the formula below:

$$\Delta TR = \left[\frac{X}{1-t}\right] \left[\frac{(E_d - 1)\, E_s}{E_s + E_d}\right]$$

where ΔTR equals change in total export revenue, t is the marginal corporate tax rate and E_d and E_s are demand and supply elasticities, respectively. The first term represents the effect (or "gross-up") of the change in tax liabilities on the revenue needed by a producer to generate a specific, after-tax rate of return. The second term represents the reaction of supply and demand to a shift in the supply schedule.[10]

---

[9] The price elasticity of demand (supply) is the percentage change in quantity demanded by (supplied to) consumers due to a unit percentage change in price.

[10] This reaction can be decomposed into two effects: (1) the increase in revenue due to the increase in sales at the new price, and (2) the decrease in revenue due to the reduction in price received on existing sales. Given the values assumed by Treasury for supply and demand elasticities, the net effect is an increase in total revenue.

In applying this formula, the Treasury uses the following procedure:

- Classification of DISC exports into four categories of products;
- Calculation, for each category, of the average value of tax deferrals per dollar of sales;
- Application of the formula to each product category using the appropriate marginal tax rate (48 percent for DISC Year 1979);
- Finally, multiplication of the percent change in value of exports for each category by the sales in each category and summation over categories to yield the total DISC-induced increase in exports.

B. Elasticity Assumptions

The key determinants of the export impact of DISC are the specific values assumed for the supply and demand elasticities. For this reason, an analysis of the Treasury's assumed elasticity values is essential in evaluating its estimates of DISC's impact.

Several empirical studies have been performed in an attempt to estimate supply and demand elasticities for U.S. exports. However, four major sources of error are often cited in connection with the reliability of available elasticity estimates:

- Aggregation bias;
- Simultaneous equation bias;
- Errors in variables; and
- Misspecification.

What is important with respect to these errors is that, with the exception of errors in variables (which biases the estimates downward), the direction of their effect is unknown. At a minimum, they introduce some uncertainty with respect to the precise magnitude of elasticity estimates.

1. U.S. Treasury Elasticity Estimates

Table III-1 presents the elasticities of demand and supply used by the Treasury in the 1979 Annual Report. The assumed supply elasticities are high because Treasury assumes that the "supply of output to foreign markets is extremely responsive since it represents the diversion of output from domestic consumption, which can be instantaneous."[11] Another argument for high supply elasticities (unstated by the Treasury) can be made in light of current economic conditions--that with high unemployment and excess manufacturing capacity, the supply of output for either domestic consumption or export is very responsive, with no diversion necessary. The relatively low supply elasticity for non-manufactured goods (mainly agricultural goods) is assumed to result from resource constraints.

Demand elasticities are assumed by Treasury to vary among the "...product categories, depending on the differentiation of products in world trade. Some products, including agricultural goods are highly standardized, and foreign demand is therefore highly elastic."[12]

---

11. 1979 Annual Report, p 2.

12. *Ibid*., p 2.

Table III-1

ELASTICITIES OF SUPPLY AND DEMAND ASSUMED
BY U.S. TREASURY IN 1979 ANNUAL REPORT

	Product Category	Supply Elasticity	Demand Elasticity (absolute values)
1.	Nonmanufactured Products	1.5-2.5	Infinite
2.	Basic Manufactures	20	6-8
3.	High Technology Manufactures	20	3-5
4.	Resource Related Manufactures	4	8-10

Source: "The Operation and Effect of the Domestic International Sales Corporation Legislation, 1979 Annual Report," U.S. Department of the Treasury, April 1981.

While Treasury's elasticity estimates seem reasonable at the level of the individual firm (or producer) they are probably inappropriate for an evaluation of aggregate demand. To illustrate this point, consider the demand elasticity cited for non-manufactured goods. These goods are mainly from the agricultural sector (about 95 percent were agricultural goods in DISC year 1979). It is true that demand elasticities are extremely high for individual producers (since they function within a nearly "perfectly competitive" market). However, the aggregate demand for these goods is in fact highly inelastic.[13]

Although the infinite elasticity of demand for non-manufactured goods is probably high, the supply elasticity assumed by the Treasury for this sector may be too low because resource constraints on this sector as a whole are less of a factor than they would be for individual firms. This argument is probably also relevant (although, to a lesser degree) to the "resource-related manufactures" sector.

2. Alternative Elasticity Estimates

Tables III-2 and III-3 present examples of supply and demand elasticities for U.S. exports cited in the literature. Most of the available estimates are for demand elasticities, and nearly all are at a more aggregate level than the four categories considered by Treasury.

---

[13] A highly inelastic aggregate (worldwide) demand elasticity for agricultural goods need not necessarily imply an inelastic aggregate demand elasticity for U.S. exports (see Artus and McGuirk, IMF Staff Papers, June 1981). It would be inconsistent with an infinite demand elasticity for these exports, however.

Table III-2

U.S. EXPORT SUPPLY ELASTICITIES CITED IN THE LITERATURE

Source	Supply Elasticity
Goldstein - Khan[1]	
Equilibrium model	6.6
Disequilibrium model	3.9
Geraci - Prewo[2]	12.2
Magee[3]	11.5

1. Goldstein, M. and M.S. Khan, "The Supply and Demand for Exports: A simultaneous Approach," Review of Economics and Statistics Vol. 60, May 1978.

2. Geraci, V.J. and W. Prewo, "An Empirical Demand and Supply Model of Multilateral Trade," Discussion Paper 80-1, University of Texas, March, 1980.

3. Magee, S.P., "Prices, Income and Foreign Trade," in P.B. Kenen (ed.), International Trade and Finance: Frontiers for Research, Cambridge University Press, 1975.

Table III-3

U.S. EXPORT DEMAND ELASTICITIES
CITED IN THE LITERATURE

Source	Demand Elasticity (absolute value)
Goldstein-Khan[1] (FIML)	2.32
Goldstein-Khan (OLS)	2.13
Hickman-Lau[2]	1.51
Houthakker-Magee[3]	1.51
Artus-McGuirk[4]	
Food	2.0
Crude Materials	2.0
Fuels	2.0
Semifinished Manufacturing	1.5
Finished Manufacturing	1.75
Horst (short-run)[5]	1.5 to 3.0
(long-run)	3.0 to 5.0
Deppler-Ripley (short-run)[6]	0.29
(cumulative)	1.52
Basevi (short-run)[7]	0.49
(long-run)	1.44
Stone[8]	
Method I	1.59
Method II	1.26

1. Goldstein, M. and M.S. Khan, "The Supply and Demand for Exports: A Simultaneous Approach," Review of Economics and Statistics Vol. 60, May, 1978. "FIML" are estimates derived through full-information maximum likelihood method. "OSL" are estimates denied using ordinary least squares.

2. Hickman, B.G. and L.J. Lau, "Elasticities of Substitution and Export Demand in a World Trade Model," European Economic Review, Vol. 4, December, 1973.

3. Houthakker, H.S. and S.P. Magee, "Income and Price Elasticities in World Trade," Review of Economics and Statistics, Vol. 51, May, 1969. Price elasticities of agricultural and non-agricultural exports were found to be similar.

4. Artus, J.R. and A.K. McGuirk, "A Revised Version of the Multilateral Exchange Rate Model," IMF Staff Papers, Vol. 28, No. 2, June, 1981. Price elasticities derived by assumption.

5. Horst, T., "An Economic Analysis of the Foreign International Sales Corporation Proposal," unpublished, September, 1981. Price elasticities derived by assumption.

6. Deppler, M.C. and D.M. Ripley, "The World Trade Model: Merchandise Trade," IMF Staff Papers, Vol. 25, No. 1, March, 1978. Cumulative equals short-run plus "long-run."

7. Basevi, G., "Commodity Trade Equations in Project LINK," in R.J. Ball (ed.), The International Linkage of National Economic Models, American Elsevier Publishing Co., 1973.

8. Stone, J.A., "Price Elasticities of Demand for Imports and Exports: Industry Estimates for the U.S., the E.E.C. and Japan," Review of Economics and Statistics, Vol. 61, May, 1979. Greater sectorial detail is available from this source.

Of the few estimates of supply elasticities, most are very high (Goldstein and Khan favor the higher estimates of their equilibrium model). In light of this, the Treasury estimates appear reasonable (except that, as mentioned above, the supply elasticity for nonmanufactured products appears to be too low). In addition, the estimates presented are not inconsistent with the assumptions used by other multilateral trade analysts, i.e., that supply elasticities, especially where considerable slack productive capacity exists, are extremely high or infinite.

The demand elasticities in Table III-3 provide less support for those used by the Treasury. Most of the empirically-derived estimates of demand elasticity cluster around 1.5, and the largest empirically derived value is 2.32. This is much smaller than the estimates used by the Treasury (except in the case of "high technology manufactures"). Horst, citing the downward bias in these estimates resulting from statistical factors, assumes long-run elasticities of between 3 and 5.

On the basis of the empirical evidence, it would appear that the Treasury has probably overstated long-run demand elasticities for U.S. exports. Given the other estimates available and the range of uncertainty associated with them, we have taken the approach of performing a sensitivity analysis using three demand elasticity cases, corresponding to low, moderate, and high response scenarios. The values used by the Treasury were used to define the "high response" scenario. Horst's elasticity estimates were used to define the "moderate response" scenario. Other empirical estimates (principally Goldstein-Khan) were used to define the "low response" scenario. Demand elasticities for all scenarios are presented in Table III-4.

Table III-4

ELASTICITIES OF SUPPLY AND DEMAND FOR LOW, MODERATE, AND HIGH RESPONSE SCENARIOS

Product Category	Supply Elasticity Scenario			Demand Elasticity Scenario (absolute value)		
	Low	Moderate	High[1]	Low	Moderate	High[1]
1. Nonmanufactured Products	4	10	2.5	2	5	Inf.
2. Basic Manufactures	10	20	20	2	5	8
3. High Technology Manufactures	10	20	20	2	4	5
4. Resource Related Manufactures	4	10	4	2	5	10

---

[1] Treasury elasticity assumption for its high response case.

As stated above, the supply elasticities used by Treasury appear reasonable except in the cases of nonmanufactured goods and resource-related manufactures, where they may be too low. A range of 4-10 for these two sectors is more appropriate. However, for the high demand elasticity response scenario, we adopted the supply elasticities that were used by Treasury. Two other scenarios for supply elasticities were used ("low and moderate response"). Scenario-specific supply elasticities are also shown in Table III-4.

C. Results of the Scenarios

Presented in Table III-5 are the implied increases in exports induced by DISC for the low, moderate, and high response scenarios. These DISC-induced exports are assumed to consist mainly of increases in output rather than diversions from domestic consumption. This result is based on the following assumptions:

- Given an adequate supply of dollars worldwide, capital invested in export production is not diverted from domestic uses.
- The current economic situation is characterized by considerable slack in the labor market and in the utilization of productive capacity. Under these conditions it is less likely that DISC-induced increases in exports will displace either capital or labor from domestic uses.

Increases in exports induced by DISC under the three response scenarios are summarized below:

Table III-5

INDUCED EXPORTS--LOW, MODERATE AND HIGH RESPONSE SCENARIOS

Products Category	Receipts (billions)	DISC Saving per $ of Sales	Increase in Value of Exports (in billions)[1]		
			Low Response	Moderate Response	High Response
1. Nonmanufactured Products	$ 26.038	.314%	$ .105	$ .419	$ .394
2. Basic Manfactures	29.898	1.030	.494	1.895	2.961
3. High Technology Manufactures	35.639	1.489	.850	2.551	3.266
4. Resource Related Manufactures	8.027	.948	.098	.390	.376
Total	$ 99.602	1.028%[1]	$ 1.547	$ 5.255	$ 6.997

---

1. Derived percent average DISC saving per dollar of sales, not a total.

Scenario	Value of DISC-Induced Exports ($ in billions)
Low Response	$1.5
Moderate Response	$5.3
High Response	$7.0

These results, ranging from a low of $1.5 billion to a high of $7.0 billion, cover a wider range of induced-export values than does the Treasury estimates. This reflects our feeling that the supply and demand elasticities are fraught with greater uncertainty than recognized by the Treasury estimates.

It should also be pointed out that these estimates reflect tax provisions in effect in DISC year 1979, and thus do not reflect implementation of the ACRS provisions of the Economic Recovery Tax Act of 1981. As we argued in Section II, at an aggregate level, ACRS reduces both the costs and benefits of DISC proportionally, although it may have a differential impact on some exporters given differences in existing capital stock.

IV. THE COSTS AND BENEFITS OF DISC

The purpose of this section is to provide a quantitative assessment of the net costs to the Federal government of the DISC provisions. For purposes of this analysis, net costs are measured as the change in tax revenues to the U.S. Treasury resulting from the deferral of corporate income taxes on a portion of profits earned from exports. Such a net cost measure must consider not only the lost tax revenues (costs) associated with DISC deferral but also the possible increased Treasury revenues (benefits) associated with the additional economic activity induced by the DISC incentive.

The U.S. Treasury, in estimating the revenue loss associated with DISC, considers only the tax losses due to the DISC deferral and not the possible revenue gains from increased economic activity. Under Treasury's method, DISC is estimated to cost U.S. taxpayers $994 million in DISC year 1979. However, when increased revenues due to the DISC-induced exports are considered, from 29 to 176 percent of the DISC costs may be recovered by Treasury. Thus, the net costs of DISC to the Federal government may be significantly reduced and may under certain assumptions produce a net benefit; that is, rather than incurring only costs, the Treasury may also collect an additional $281 to $1,374 million in revenues when exports are encouraged through DISC.

This section includes the following subsections:

- A discussion of the methods for measuring the net costs of DISC;
- A review and critique of the Treasury estimates of DISC costs; and

- A quantitative example of the net costs of DISC when feedbacks from DISC-induced exports are considered.

A. Methods of Measuring the Net Costs of DISC

There are essentially three general approaches to measuring the costs of a tax incentive. At the one extreme is the most complete approach which views the tax incentive in the context of total economic activity and calculates the net changes caused by the incentive. A second less general approach is to isolate some of the major cost implications of a tax incentive by considering some behavioral responses and initial feedbacks on Treasury revenues and other Federal government outlays. The third and least general approach is one which looks at the tax incentive in total isolation without considering behavioral responses or any revenue feedback implications.

These three general methods may be categorized to the extent they account for the complex set of interactions caused by a tax incentive as follows:

- Full feedback (or general equilibrium) analysis;
- Partial feedback analysis; and
- No feedback analysis.

Each of these methods has some obvious strengths and weaknesses.

The full feedback approach is the theoretically correct method for net cost analysis, but it is often impossible to implement in its purest form. Full feedback analysis provides the most complete picture of economic activity with and without a tax incentive. Such an analysis would consider not only the complex interactions that occur at any point in time but also how these economic interactions may change overtime and their associated feedbacks. While many of the macro and micro models attempt to capture this complexity, they are at best first approximations and too crude to analyze the impacts of a program with effects as complicated as those of DISC. Thus, the strength of the full feedback approach--an identification of the complex interactions necessary for true net cost analysis--is also its chief weakness since data and modeling limitations preclude its full application.

The partial feedback approach attempts to quantify the major feedbacks associated with responses to a tax incentive. Partial feedback analysis includes quantification of some of the following:

- Net changes in Federal, state, and local taxes due to direct and indirect impacts on economic activity;
- Net changes in taxes from balance of trade adjustments associated with induced changes in exports and imports;
- Net impact on tax revenues through changes in the general price level caused by the funding mechanism for the tax provision (i.e., increased government borrowing); and
- Changes in government outlays such as various transfer benefits that may be indirectly affected by the tax incentive.

Each of these major impacts involves complex sets of interactions many of which occur simultaneously.

The major weakness of the partial feedback approach is that it is by definition partial. Thus, not all potential impacts are quantified and the result may be affected by the types of feedbacks that are quantified. Some of the non-quantified or "non-quantifiable" feedbacks may be significant and could alter conclusions. Moreover, given behavioral uncertainties and data limitations, quantification requires numerous explicit and implicit simplifying assumptions about the environment in which the tax incentive is evaluated. Whether performed with a sophisticated model or on the back of an envelope, the final result from a partial feedback analysis must be considered suggestive and not predictive. The results must be evaluated according to the reasonableness of the assumptions and with a recognition of the sensitivity of the results to other feedbacks that may or may not be easily quantifiable.

The no feedback approach is probably the least useful of the three approaches for assessing the net costs of a tax incentive.[14] This approach views the tax incentive in isolation and answers the question of how Treasury revenues would change if the incentive item were subject to taxation and there were no behavioral responses. The major attraction of this approach is that it involves a rather straightforward calculation that can be applied unambiguously to a variety of tax incentive programs.[15] Its major weakness, of course, is that there are many feedbacks, some obvious, that could significantly alter the net cost assessment of a tax incentive such as DISC.

---

[14] The Treasury tax expenditure estimates discussed in the next section are examples of the no feedback approach.

[15] Each year, both the executive and legislative branches do such mechanical calculation when they attempt to quantify numerous tax expenditures as part of the Federal budget evaluation process.

In the final analysis, the full feedback approach, although theoretically pure, is impossible to implement. The no feedback approach is too restrictive in its no feedback assumption and is therefore indefensible as a measure of net costs. Partial feedback analysis strikes a compromise between these two extremes.

B. Treasury Estimates of DISC Costs

The Secretary of the Treasury issues annually a report to Congress that describes the operations and effects of DISC.[16] This report includes detailed revenue impact estimates of DISC for the report year based upon a sample of DISC returns and also forecasts DISC revenue impacts for future years. The latest report estimates the revenue loss associated with DISC to be $994 million for DISC year 1979. With the publication of an annual report (seven to date), DISC is probably one of the most carefully reviewed and analyzed tax provisions in the Federal budget. This remains true even though there are many others that are much larger in dollar terms.

1. Treasury Method

The U.S. Treasury employs the no feedback approach to estimate the DISC revenue loss. Treasury calculates the Federal revenues foregone by the deferral of DISC income from the corporate profit tax. The calculation is performed by applying the marginal corporate income tax rate to the deferred income as measured from a sample of DISC returns.[17] For example, in DISC year 1979 (calendar year 1978 income) 7,208 DISC returns reported $99.6 billion in gross receipts and $6.4 billion in net income. The tax deferral component of this net income for DISC was $2.1 billion and thus the taxes foregone as estimated by Treasury were $994 million (i.e., $2.1 billion times .48).

---

[16] See "The Operation and Effect of the Domestic International Sales Corporation Legislation, 1979 Annual Report," U.S. Department of the Treasury, April 1981.

To estimate revenue losses, Treasury treats DISC as a "tax expenditure" and performs a mechanical calculation which is consistent with tax expenditure analysis as required under law, to be performed by agencies in both the executive and legislative branches of government.[18] This "static" (no feedback) analysis involves several restrictive assumptions:

---

17. The marginal tax rates used in these calculations were 48 percent for calendar years 1972-1978 and 46 percent for 1979 and subsequent years. DISC Year 1979 is essentially calender year 1978 income.

18. The Congressional Budget Act of 1974 requires the executive and legislative branches to list and estimate tax expenditures in the Federal budget. Tax expenditures are defined in the Act as ". . . those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption or deduction from gross income or which provide a special credit, a preferential rate of tax or deferral of tax liability." By this definition, both branches of government have listed DISC among the Federal tax expenditures. For example, see "Tax Expenditures," Special Analysis G, The Budget of the United States Government, 1983; "Estimates of Federal Tax Expenditures for Fiscal Years 1982-1987," Joint Committee on Taxation, U.S. Congress, March 8, 1982; and "Tax Expenditures: Current Issues and Five-year Budget Projections for Fiscal Years 1982-1986," Congressional Budget Office, U.S. Congress, September 1981.

- No other features of the tax system change;
- Individuals or businesses do not alter their behavior as a result of the tax expenditure elimination;
- There are no policy changes that mitigate the effects of removing the tax expenditure; and
- There are no indirect feedback effects in terms of economic activity that may alter Treasury tax revenues and government budget outlays.

The Treasury DISC cost calculation is illustrated graphically in Figure IV-1. With the DISC tax deferral, total exports are shown as quantity Q_1, the price of these exports is represented by P_1, and the dollar value of these exports (gross income) is represented by rectangle P_1AQ_1O. The revenue loss on DISC deferred income is represented by rectangle P_1ABP_3.

2. Limitations of the Treasury Method

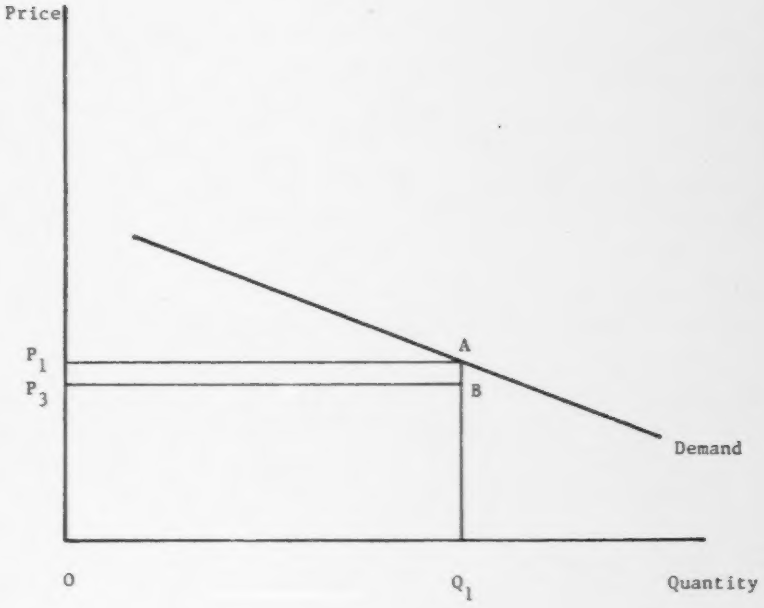
The Treasury revenue loss estimates for DISC are flawed for the purpose of net cost calculation in three general areas:

- Overstatement of Direct Revenue Losses from taxes avoided on DISC income;
- Omission of Indirect Revenue Gains from increased economic activity caused by DISC; and
- Omission of Indirect Impacts on budget outlays associated with changes in economic activity caused by DISC.

Direct Revenues Losses. By its own admission, Treasury indicates that its revenue loss estimates of DISC may be different from the true cost of DISC. One reason for the divergence is the assumption that there is "no behavioral

Figure IV-1

MARKET FOR U.S. EXPORTS
WITH DISC



response" to the DISC incentive in the Treasury revenue loss calculation. Yet Treasury states that "in reality, economic responses may make the true revenue cost [of DISC] different from the $994.2 million estimate [for DISC year 1979]."[19]

This "no behavior response" assumption is inconsistent with Treasury's own assumptions and calculations regarding the responsiveness of exports to the DISC incentive. Assuming that demand and supply for U.S. exports are sensitive to price (i.e., elastic) Treasury estimated that the DISC incentive increased the dollar value of U.S. exports by between $4.5 to $7.0 billion. Our own estimates establish a range of $1.5 to $7.0 billion as the value of exports induced by DISC. Yet, the revenue effects of these increases are not properly accounted for in Treasury's own DISC revenue loss calculations.

A simple example will help demonstrate the potential bias in the Treasury estimates. Figure IV-2 illustrates some of the changes that must be considered in identifying the true cost of DISC.

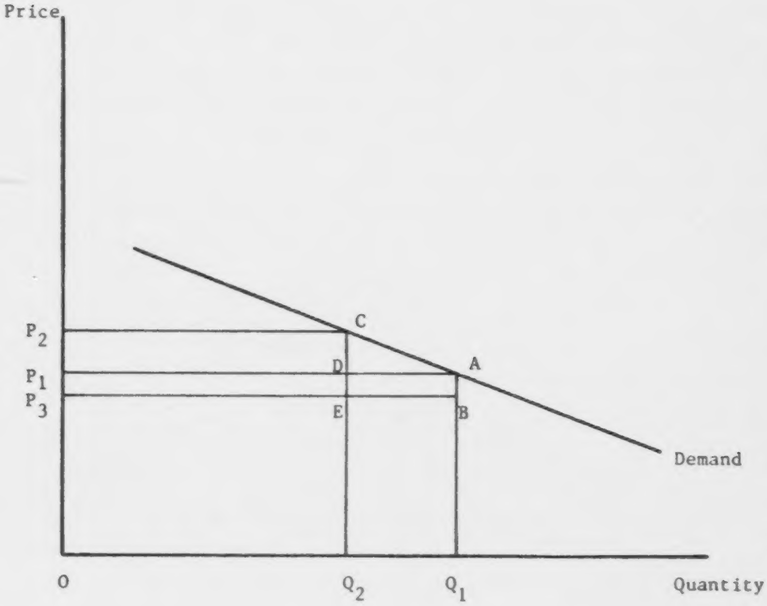
In the absence of DISC, exporters would charge a higher price for their goods to recover the same income otherwise deferred through DISC. With DISC, the tax benefit per unit of output sold on the world market is P_1-P_3. Without DISC, U.S. suppliers

---

[19] 1979 Annual Report, p. 18.

Figure IV-2

MARKET FOR U.S. EXPORTS
WITH AND WITHOUT DISC


Price
C
A
D
E
B
P_2
P_1
P_3
Demand
0
Q_2
Q_1
Quantity

charge a price per unit of P_2 to realize the same after tax rate of return. This higher price reflects the additional cost of income no longer deferred through DISC.[20]

Assuming a downward sloping demand curve for U.S. exports, a rise in the price leads to a reduction in the quantity of U.S. goods sold in the world market. In this example, without DISC U.S. suppliers price their goods at P_2 which leads to a reduction in the quantity demanded to Q_2; the value of U.S. exports falls to the area represented by rectangle P_2CQ_2O (assuming that demand is price responsive, i.e., elastic). The corporate tax on this additional income is obtained by applying the marginal tax rate to rectangle P_2CDP_1. This additional tax revenue, approximately equal to the area of rectangle P_1DEP_3, represents the "direct" revenue losses associated with DISC.

Figure IV-2 illustrates the bias of the Treasury "no behavior response" assumption in their DISC revenue loss estimates. Treasury obtains its "direct" revenue loss estimate as rectangle P_1ABP_3. With the reduction in exports associated with the elimination of DISC, however, the true "direct" revenue loss caused by DISC is rectangle P_1DEP_3. In other words, Treasury overestimates revenue losses by including taxes on DISC deferred income from exports induced by DISC; that is, the rectangle

---

[20] In terms of Figure IV-2, $P_2-P_1 = (P_1-P_3)/(1-t)$, where t is the marginal tax rate on corporate income.

DABE.[21] Counting these revenues as part of the cost of DISC is inappropriate since they would not exist in the absence of DISC.

Indirect Revenue Effects. The Treasury tax loss estimates do not reflect the indirect revenue effects of DISC induced changes in economic activity. Under certain conditions, particularly when there are unemployed resources in the economy, Treasury may recover some of the initial revenue loss of the DISC tax incentive. These feedbacks or revenue benefits may be the result of taxes collected on income from DISC-induced economic activity. If DISC-induced exports increase national income, then the Treasury will realize additional corporate and personal income taxes and other revenues will be generated including payroll taxes and various state and local taxes.

The previous example illustrates the offset principle when exports are induced by DISC. As indicated in Figure IV-2, DISC increases the level of U.S. exports from Q_2 to Q_1. Assuming demand is elastic, the total value of U.S. exports will increase; that is, rectangle DAQ_1Q_2 is greater than rectangle P_2CDP_1. The value of this difference will increase with greater price sensitivity (i.e., higher elasticities). Recall that rectangle DABE represents the DISC revenue loss on DISC-induced exports. Therefore, rectangle EBQ_1Q_2 represents additional income that may be taxed and will provide Treasury with additional revenues and reduce the cost of DISC. For example, DISC rules only allow 50 percent of net income on incremental receipts to be deferred leaving the Treasury with corporate taxes on the remaining income from DISC-induced exports. The DISC-induced exports will also increase total wages and salaries on which the Treasury will collect additional personal income taxes and, to the extent that unemployment or underemployment exist in the absence of DISC, Treasury will realize additional payroll taxes.

---

[21] This simple example assumes that resources used in the production of DISC exports are not diverted from elsewhere. Such an assumption is reasonable in an economy with excess capacity and unemployed resources as is the case with the current U.S. economy.

Budget Outlay Effects. A net increase in exports may also lead to reductions in some Federal outlays. In particular, it is possible that the Federal government may spend less on transfer programs as a result of the employment induced by DISC. It is obvious that unemployment insurance costs may decline but equally important, though less obvious, may be the savings in some welfare programs such as Food Stamps and Aid to Families with Dependent Children.

To summarize, the Treasury revenue loss estimates for DISC are "static" and do not consider the variety of responses that may occur as a result of the tax incentive. Among the most important is the increased economic activity stimulated by the DISC incentive. In performing a "direct revenue" loss calculation Treasury counts as part of the loss deferred taxes from DISC-induced exports, a clear overstatement of DISC costs. Though by Treasury's own estimates DISC increases exports, Treasury does not calculate the indirect revenue increases associated with these exports. These revenues obviously reduce the cost of DISC. Finally, though difficult to quantify, the Treasury estimates do not reflect outlay savings in various transfer programs from increased output under DISC.

C. A Quantitative Example of Net Costs

For DISC year 1979, Treasury estimates that DISC cost the taxpayers $994 million in foregone revenues in order to generate $4.5 to $7.0 billion in additional U.S. exports. By our own estimates, DISC-induced exports range between $1.5 and $7.0 billion, with the moderate price responsiveness scenario suggesting DISC-induced exports of $5.3 billion.

An obvious question is the magnitude of additional tax revenues (benefits) due to these induced exports. In this simplified partial feedback example, net costs of DISC are computed by offsetting against the Treasury revenue loss estimate the following revenue feedbacks associated with DISC-induced exports:

- Additional corporate tax liabilities;
- Additional personal tax liabilities; and
- Additional payroll taxes.

Overall, when the feedback effects of induced exports are considered, Treasury recovers 29 to 176 percent of the initial DISC revenue losses from additional tax collections.[22]

---

[22] Additional revenues from taxes on are supplier nonwage income are not considered.

1. Moderate Price Response Scenario

The following is a quantitative example of the DISC net cost calculation for the moderate price response scenario; that is, $5.3 billion of DISC-induced exports. The feedback calculations for the various price response scenarios are summarized in Table IV-1 and IV-2.

Treasury's $994 million DISC cost estimate includes lost revenues on all exports including those exports induced by DISC. As indicated earlier, the deferred taxes on DISC-induced exports should not be considered a cost of DISC, since in the absence of DISC exports would decline. Thus, the Treasury estimate should be reduced by $161 million (Table IV-2--revenue loss on induced exports) to obtain the true direct cost of DISC of $833 million for the $94.3 billion in exports that would occur in the absence of DISC.[23]

Assuming that the $5.3 billion induced exports represent a net increase in domestic output, the Treasury realizes additional revenues in several taxes on income. These indirect revenue effects are the result of increased profits that are subject to the corporate income tax; and increased wages and salaries that are subject to personal income and payroll taxes. The net effect of considering these sources of revenue is to offset more than the initial costs of DISC to the Treasury.

---

[23] For purposes of this example, we have assume that these induced exports meet the incremental sales requirement; that is, 50 percent of DISC profits are deferred from taxation.

Table IV-1

NET COST OF DISC
BASED UPON PARTIAL FEEDBACK
OF REVENUES FROM INDUCED EXPORTS
ASSUMING A MARGINAL PROFIT RATE OF 6.4 PERCENT
DISC YEAR 1979
($ in millions)

	Low Response	Moderate Response	High Response
DISC Induced Exports	$1,547	$5,255	$6,996
Revenue Cost			
Treasury Estimate	$994	$ 994	$ 994
Less: Revenue Loss on Induced Exports	24	81	107
Revenue Loss	970	913	887
Net Cost of DISC			
Revenue Loss	$ 970	$ 913	$ 887
Less: Corporate Income Taxes	24	81	107
Individual Income Taxes 1,2	133	451	600
Payroll Taxes 3	124	420	559
Net Cost of DISC 4	$ 689	$ (39)	$ (379)
Revenues Recovered as a Percent of Revenue Loss	29%	104%	143%

1. Based on the distribution of 66 percent of the value of DISC-induced exports to labor in the form of wage and salary increases (see footnote 25).

2. Based on an average effective tax rate of 13 percent of labor income. Effective tax rate assumptions from Statistics of Income: 1978 Individual Income Tax Returns, published by U.S. Internal Revenue Service. Average wage rate assumptions from Employment and Earnings, published by U.S. Department of Labor. This tax rate assumes that half of all DISC-induced labor income is received by previously unemployed households and half is received by households already earning the average industry wage rate (on an annual basis).

3. Based on employer and employee contributions, each of 6.05 percent of all wages and salaries paid, assuming all workers' wages were below the $17,700 maximum during calendar year 1978.

4. Components may not sum to totals due to rounding.

Table IV-2

NET COST OF DISC
BASED UPON PARTIAL FEEDBACK
OF REVENUES FROM INDUCED EXPORTS
ASSUMING A MARGINAL PROFIT RATE OF 12.8 PERCENT
DISC YEAR 1979
($ in millions)

	Low Response	Moderate Response	High Response
DISC Induced Exports	$1,547	$5,255	$6,996
Revenue Cost			
Treasury Estimate	$ 994	$ 994	$ 994
Less: Revenue Loss on Induced Exports	48	161	215
Revenue Loss	946	833	779
Net Cost of DISC			
Revenue Loss	$ 946	$ 833	$ 779
Less: Corporate Income Taxes	48	161	215
Individual Income Taxes 1,2	133	451	600
Payroll Taxes 3	124	420	559
Net Cost of DISC 4	$ 641	$ (199)	$ (595)
Revenues Recovered as a Percent of Revenue Loss	32%	124%	176%

1. Based on the distribution of 66 percent of the value of DISC-induced exports to labor in the form of wage and salary increases (see footnote 25).

2. Based on an average effective tax rate of 13 percent of labor income. Effective tax rate assumptions from Statistics of Income: 1978 Individual Income Tax Returns, published by U.S. Internal Revenue Service. Average wage rate assumptions from Employment and Earnings, published by U.S. Department of Labor. This tax rate assumes that half of all DISC-induced labor income is received by previously unemployed households and half is received by households already earning the average industry wage rate (on an annual basis).

3. Based on employer and employee contributions, each of 6.05 percent of all wages and salaries paid, assuming all workers' wages were below the $17,700 maximum during calendar year 1978.

4. Components may not sum to totals due to rounding.

The increase in exports increases profits, some of which will be subject to the corporate income tax. For example, according to the 1979 DISC Annual report, the average profit margin on DISC sales is 6.4 percent. However, given that costs consist of fixed and variable components, the profit margin on the last dollar of sales should be greater than 6.4 percent. In our analysis, we used both the average profit margin (Table IV-1) and twice the average or 12.8 percent (Table IV-2). The following discussion is based on a 12.8 percent rate of profit. Thus, the corporate profits on $5.3 billion of induced exports would be about $673 million. Assuming that 50 percent of these profits are deferred through a DISC (all of the increase is assumed to pass the incremental test), then $336 million is taxed at the corporate income tax rate of 48 percent,[24] yielding $161 million in additional corporate profit tax revenues.

The $5.3 billion induced exports will increase wages and salaries and the associated personal income and payroll taxes.

---

[24] The rate in effect for DISC year 1979 (calendar year 1978 income).

Assuming that 66 percent of the increase in sales translates into wages and salaries,[25] then $3.5 billion in income may be subject to taxation. If the marginal income tax rate is 13 percent (this assumes that one half of the additional income goes to households with no previously employed workers, a conservative assumption), then the additional wages and salaries will generate additional personal income tax revenues of $451 million. Payroll tax revenues will also increase. Assuming that the $3.5 billion is subject to the rate on employers and employees, 12.1 percent, then payroll tax revenues will increase by $420 million.

The increased exports will also leave suppliers with additional income through payments to suppliers for increased intermediate materials. These increased payments to suppliers will obviously have some feedbacks to the Treasury, though they are difficult to quantify and are not included here. Ultimately, however, all receipts are a return to labor, a return to capital, or a rent, and are subject to Federal tax.

---

[25] Based on an average of (1) the proportion (for calendar year 1978) of domestic income for non-financial corporate business represented by wage and salary income of employees and (2) the proportion (for calendar year 1978) of net domestic product for non-financial corporate business represented by wage and salary income of employees. Domestic income differs from net domestic product in that the former includes "indirect business taxes and nontax liabilities plus business transfer payments less subsidies." We averaged the labor income proportion for the two measures because the increment to national product resulting from the DISC-induced exports would probably cause some marginal (but undetermined) increase in indirect business taxes. (Source: Survey of Current Business: Special Supplement, July 1981, U.S. Department of Commerce.)

To summarize, the $833 million "true" initial revenue cost of DISC will be more than offset by the following revenues collected from taxes on induced exports:

	Revenue Feedbacks ($ in millions)
Corporate Income Taxes	$ 161
Personal Income Taxes	451
Payroll Taxes	420
Total	$1,032

As a result of these offsets, for every dollar spent on DISC, the Treasury recovers through other taxes $1.24.[26]

2. Other Feedbacks

This simple feedback analysis considers only the major initial feedbacks on the Treasury and does not consider potential feedbacks from subsequent rounds of economic activity. Beyond the tax revenues from induced incomes to suppliers, state and local governments may also realize revenue benefits from DISC. Also, to the extent that unemployed or underemployed resources are devoted to the production of DISC-induced exports (the assumption of the analysis), Federal as well as state and local governments will realize reductions in transfer payments such as welfare and unemployment compensation.

---

[26] This analysis requires the following two assumptions: exports represent a net increase in U.S. output and in the U.S. balance of trade. These and other assumptions are discussed in Section V.

When subsequent rounds of economic activity are considered, the Federal government will realize additional benefits from the DISC-induced exports. For example, a study to assess the cost effectiveness of an Eximbank subsidy program found that when the "ripple effects" on the economy over the life of the project are considered, the output effects may be more than double the expenditure on the project.[27]

---

[27] See Wharton, EFA, Inc., "Budd Company and Westinghouse Electric Corporation Buenos Aires Subway Car Contract: Net Impact on the Government of Export-Import Bank Financing," 1981.

V. SOME ECONOMIC IMPACTS OF DISC IN A GENERAL EQUILIBRIUM FRAMEWORK

The major criticism of partial feedback analysis is that only the major, direct effects of a policy are considered. By neglecting other effects, particularly those that operate indirectly, the results of partial feedback analysis may be biased. Effects that are assumed to be unimportant may, on further analysis, operate to offset or augment the desired results of a program.

The partial feedback analysis described in the preceeding section requires several assumptions to quantify the effects of DISC on Treasury revenues. Two critical assumptions will be examined in this section. These assumptions are:

- The induced exports represent a net gain in the U.S. balance of trade, and
- The induced exports are a net increase in output for the U.S. economy.

In the short run, both these assumptions are plausible, though over time some offseting adjustments are likely to occur. Certainly today the U.S. economy is characterized by excess capacity and considerable unemployment. Thus, induced exports will likely add to, rather than be at the expense of, production for the domestic economy. Balance of trade adjustments depend critically on how increases in U.S. exports will affect exchange rates. In the short run, changes in the value of the U.S. dollar may be small. However, over time some appreciation in the value of the dollar can be expected which will lead to both an erosion of U.S. exports and an increase in U.S. imports.

In this section, we discuss the implications of these assumptions on domestic markets and international trade. Specifically, the effects of alternatives to these assumptions are considered by reviewing the potential impacts on overall economic efficiency and the responsiveness of foreign markets to the export incentives.

A. The Effects of DISC on the Balance of Payments

In Section IV, it was shown that DISC operates to increase net revenues from export activities. Essentially, there are two mechanisms for this increase. First, by decreasing the after tax cost of capital used in the production of exports, DISC increases the attractiveness of investing in export activities as compared to production for domestic use. Firms maximize profits by increasing their use of capital for export production. Second, the reduction in cost permits charging a lower price for exported products. If the demand for these products is elastic, total revenues will increase.

A net increase in revenues from exports, all other things equal, improves the balance of payments. This subsection presents several alternative views regarding the secondary effects of increased export revenues on the exchange rate and on the terms of trade.[28] This question is addressed to determine whether DISC creates effects in the foreign exchange markets which tend to offset the expansionary effects of DISC on output and employment.

---

[28] The terms of trade of country A is the number of units that it can import from country B in exchange for one unit of its exports.

1. Initial Effects of the Increase in Export Revenues

The initial effect of an increase in revenues from export activities is to improve the balance of payments and decrease the terms of trade. A decrease in the price of exported goods, all other things being equal, requires the United States to sell a larger quantity of exports to earn the same amount of foreign exchange. The terms of trade deteriorate because the price of U.S. export goods declines while the price of import goods, initially, is constant. The balance of payments improves, however, because substantially more export goods can be sold at this reduced price. The increase in the quantity of exports more than offsets the reduction in price because the foreign sector has an elastic demand for imports.

Foreign consumers cannot purchase U.S. commodities directly. Because U.S. commodities are priced in dollars while foreign consumers hold other currencies, foreign consumers must first purchase dollars in the foreign exchange market. If the exchange rate is freely-floating, the value of the dollar may change. To the extent that the dollar value of exports rises, the demand for dollars in the foreign exchange market will increase and its price, relative to other currencies, will increase. An appreciation of the dollar will affect all commodities that the U.S. purchases or sells internationally. Imports will become relatively less expensive to U.S. consumers and exports relatively more expensive to foreign consumers, resulting in an increase in imports and a decrease in exports. These exchange rate effects may partially offset the initial expansion of exports that was attributed to DISC.

The simple result of a reduction in the price of exports leading to an appreciation of the dollar is not so straightforward in practice, however. A variety of factors affect the exchange rate including current and expected rates of inflation, interest rates, barriers to trade, and foreign exchange controls. There exists considerable controversy regarding the influence of speculation on the exchange rate, including the possibility that speculation causes the exchange rate to move farther away from an equilibrium value.[29] There are also indications that governments are actively intervening in the foreign exchange markets in order to fix the price of their currencies relative to other currencies. For example, the Japanese government may seek to keep the yen undervalued relative to the dollar.[30] If it is true that exchange rates fluctuate under a so-called "dirty floating" system, then any forecast based upon a simple theoretical model--that an increase in export revenues will cause an appreciation of the dollar and a subsequent reduction in exports and increase in imports--will not be accurate.

Because exchange rates depend on a multitude of factors, it is impossible to estimate accurately the impact of DISC on the exchange rate of the dollar. While the initial effect of a DISC-induced increase in export revenues is to exert upward pressure on the dollar, this pressure may not be substantial due to the importance of other factors. In addition, the effectiveness of DISC in increasing exports has other economic consequences which separately affect the trade balance and the exchange rate. It is to these effects that we now turn.

---

[29] Baumol, W.J., "Speculation, Profitability and Stability," Review of Economics and Statistics, August 1957, pp. 253-271.

[30] "A Yen Too Cheap," The Economist, March 20-26, 1982.

2. Long-term Effects of the Increase in Export Revenues

In a general equilibrium analysis, the effects of DISC on the U.S. economy and the foreign economy must be considered to determine whether DISC causes upward pressure on the exchange rate. In turn, these effects depend on characteristics of the domestic and foreign economies and on the method of financing the tax incentive offered by DISC. The principal methods of financing DISC are as follows:

- A reduction in the government budget surplus;
- An increase in general income taxes;
- A reduction in government purchase of goods and services; and
- An increase in government borrowing.

Each of these methods of financing DISC has effects on the foreign and domestic economies independent of the increase in U.S. exports. The net effect of DISC on exchange rates depends on the interaction of the export effects and the financing effects.

Government Budget Surplus. If the DISC tax adjustment is financed through a reduction in a government budget surplus, there is no financing effect on the domestic economy. DISC has a depressing effect on foreign incomes, however, as U.S. exports displace foreign production (either in the country that purchases U.S. goods or in the country that otherwise would have exported the goods to the receiving nation). But U.S. exports depend partially on the incomes of receiving nations and, to the extent that these incomes decline due to reduced exports, the upward pressure on the exchange rate is reduced.

General Income Taxes. On the other hand, if an income tax is used to offset the DISC program, U.S. imports may decline as reduced disposable income lowers demand for imports. This import reduction may offset the export reduction that results from declining foreign incomes.

Government Purchases of Goods and Services. Similarly, a reduction in government expenditures, ceteris paribus, reduces domestic income and, consequently, imports. This effect is offset to the extent that increased resource use by the private sector increases national income. Generalizing, then, financing through an income tax or through a reduction in government purchases, exerts upward pressure on the exchange rate if the increased export revenues (resulting from a decrease in the price of exports) plus the decline in U.S. imports (due to a decline in disposable income) exceeds the decline in foreign imports caused by a decline in foreign disposable income.

Government Borrowing. Alternatively, the DISC program may be financed by government borrowing. If borrowing displaces private sector borrowing, the macroeconomic result will be analagous to the use of an income tax, except for differing distributional effects. On the other hand, the government may be borrowing capital that the private sector is reluctant to invest due to perceived adverse business conditions. Thus, the government will use funds that otherwise would not be employed. This case is analogous to a reduction in the government surplus.

Summary of Long-term Effects. The effect of DISC on appreciation or depreciation of the dollar depends, therefore, on the elasticity of the demand for U.S. exports, the method of financing DISC, on the relationship between U.S. income and U.S. imports and between foreign income and foreign exports, and on the effect of changes in government expenditures on the U.S. economy. In addition, a number of factors affect the speed at which the exchange rate adjusts; these factors may render the outcome even less determinate.

If the increase in U.S. exports is financed by the foreign nations through U.S. bank loans, the initial effects (from the U.S. point of view) are an export of goods on the current account and a outflow of funds on the capital account. These effects, in terms of the overall balance of payments, cancel and have no effect on the exchange rate. As the loans are repaid, however, the repayment improves the balance of payments and puts upward pressure on the exchange rate. While alternative scenarios are possible, it is significant that under one likely scenario the employment and output effects of the increased exports are realized initially, while the exports induce a movement in the exchange rate only over time.

3. Summary

There is no doubt that in a system of freely floating exchange rates an increase in the value of exports, all other things being equal, will tend to cause the exchange rate of the exporting nation to appreciate. There exist, however, circumstances in which the exchange rate will depreciate. There also exist a large number of factors which must be held constant for this general result to hold. Changes in the money supply or the rate of interest by the central bank, for example, can offset a movement in exchange rates resulting from increased exports. There is considerable question, given the behavior of foreign currencies, whether exchange rates are freely-floating. Because of the large number of diverse factors affecting the exchange rate, the impact of DISC in this area must be regarded as uncertain.

B. The Effects of DISC on the Net Output of the U.S. Economy

The partial feedback analysis in Section IV assumed that DISC-induced exports resulted in a net increase in output of the U.S. economy. DISC is assumed to result in the use of resources that would otherwise be unemployed. If instead DISC shifts resources from one sector to another, the increase in output in some sectors must be offset by the loss of output in other sectors. In this case, the total effect of DISC on output and employment will be indeterminate.

DISC may affect total output in one of two related ways. First, DISC may change the total amount of capital employed in the economy. Second, DISC may change the economic efficiency of society. We will consider both of these effects in examining our assumption of increased output.

As discussed in Section II, DISC reduces the cost of capital employed in export activities. Investment projects evaluated against this reduced cost of capital appear more favorable and are more likely to be undertaken. Capital will be deployed to these investment projects. To establish the validity of the assumption of a net increase in output, the source of this capital must be identified.

If we assume the converse--that no net increase in employed capital results--we must implicitly assume that the supply of capital to these industries is infinitely inelastic. This assumption is unrealistic. First, with the development of the Eurocurrency market, the cost of capital is largely determined in international markets. The volume of credit handled in these markets is extremely large. Given the size of these markets relative to the financing requirements of DISC-induced exports, it is likely that these additional requirements can be met without affecting the cost of capital. Second, even if the cost of capital rises, the returns to savers will also rise. The increased returns available will affect the consumption/saving behavior of individuals and result in increased savings and increased investment funds.

For these reasons, we are persuaded that a net increase in capital investment occurs as a result of DISC. Taken from the point of view of the U.S. economy, the allocation of capital is not a zero-sum game in which increased capital formation in one sector requires decreased capital formation in another sector. New capital can be obtained either from foreign sources or from increased saving--either domestic or foreign.

The availability of labor is obvious. Given the current high rates of unemployment, we reject any assumption that increased demand for labor in one sector cannot be met without diverting labor from other sectors.

An additional possible source of increased total output due to DISC is an increase in economic efficiency. An improvement in economic efficiency means that the economy can produce a greater level of output with a fixed set of resources. Thus, even if the assumption of increased resources is not met, output may be increased if current resources are used more efficiently.

In general, economic theory holds that artificial incentives will reduce the efficiency with which economic output is generated. If we consider a program offering tax incentives to a segment of the economy to encourage specific activities, a loss of efficiency results from the increased rate of return available in those sectors. The existence of higher rates of return in these sectors causes the diversion of productive inputs from other sectors until after-tax rates of return are equalized across all sectors. Under these circumstances, society has moved away from more optimal distribution of production capacity toward a less optimal distribution.

As a practical matter, it is difficult to determine the efficiency effects of any specific tax incentive because we live in a world which does not treat all productive capacity equally. In the United States alone, the existence of our complicated tax structure causes a loss in efficiency from the "optimal" point through a system of credits, exemptions, etc. Further, biases in the worldwide economy are introduced as a result of the differences in tax treatment across national boundaries.

Under the current situation, it is reasonable to suppose that certain tax incentives may increase economic efficiency by introducing changes in the tax law which make it more neutral in its treatment of factors of production. There are certain conditions under which this might occur. These conditions are categorized under two broad headings below. Under the first heading, we discuss conditions under which tax changes might increase efficiency within one nation. In the second section we discuss conditions under which tax changes might increase worldwide efficiency.

1. National

Within the U.S. four major sources of non-neutrality in the tax treatment of capital have been cited which may introduce distortions in the distribution of capital across sectors and/or in the distribution of economic assets among capital and other productive inputs (both within and across sectors). These are:

- Depreciation Schedules. Many analysts believed that the CLADR depreciation schedules in force prior to the passage of ERTA (Economic Recovery Tax Act of 1981) introduced distortions into the treatment of capital versus non-capital inputs to production. CLADR, for instance, was often cited as a major retardant to the adoption of energy conservation by manufacturing firms because fuel expenditures could be expensed (written-off in the year incurred) while most investments in energy conservation had to be depreciated over their lifetime. The effect of ACRS (Accelerated Cost Recovery System) depreciation schedules is to promote greater capital investment than under CLADR. Whether, however, ACRS eliminates or merely reduces any bias against capital investment inherent in the tax code as a whole is problematical.

- Double-taxation of Dividends. Returns to capital paid to individuals through corporations are subject to double taxation--first at the corporate level and then at the individual level. This reduces the effective rate of return on capital investments, which, in turn, increases the return required by individuals for such investments. The result is a bias against corporate capital investments relative to other types of investments.[31]

---

[31] Boskin estimates the welfare losses associated with U.S. tax treatment of returns to capital at $50 billion annually. See M. Boskin, "Taxation, Saving, and the Rate of Interest", Journal of Political Economy (April 1978, Pt. 2).

- Treatment of Public vs. Private Capital. Public capital (e.g., schools, hospitals, roads) is exempt from tax in the U.S. while private capital is not exempt. Horst[32] and others have argued that this introduces a bias against investment in private capital. In Horst's view, any proposal which reduces the marginal rate of taxation on any portion of private capital investments would promote a more efficient allocation of capital in the U.S.

The effect of any of these three aspects of the tax code on the treatment of capital in light of other provisions of the tax code is not clear. If, on balance, the tax code is biased against private capital (either in relation to other productive inputs or in relation to public capital), special tax incentives which reduce or eliminate these biases would increase economic efficiency.

2. International

There are two general conditions under which the existence of an export-oriented tax incentive (such as DISC) in one nation might increase worldwide economic efficiency.

- Reduction of Trade Barriers. In many cases specific national markets are partially insulated from competition through the application of tariffs or through structural factors. If price reductions which result from export incentives are large enough, they may serve to overcome such barriers and open new markets.
- Reduction of U.S. Disadvantage. The worldwide tax structure may be nonneutral in its treatment of investments in the U.S. versus competing locations. For

---

[32] Thomas Horst, "An Economic Analysis of the Foreign International Sales Corporation Proposal," September 1981 (unpublished).

> instance, nearly all other nations offer export incentives which are frequently more generous than those contained in DISC. Under these conditions, DISC may help redress an existing imbalance and promote increased economic efficiency.

3. Result of Increased Economic Efficiency

The result of an increase in economic efficiency would be an increase in the level of output and income. If such an efficiency increase could be brought about through an export-oriented tax incentive, such an incentive would also increase the level of exports and imports. Exports would increase from those sectors which possessed a comparative advantage in the world market and imports would be increased for those sectors where American producers were at a comparative disadvantage in world markets. The welfare of U.S. producers and consumers would increase.

VI. THE EFFECTS OF ELIMINATING DISC

This section reviews the costs and benefits of DISC and summarizes the revenue implications of repealing the DISC provisions. The effects of DISC are considered before and after implementation of the Accelerated Cost Recovery System (ACRS) established under the Economic Recovery Tax Act of 1981. Overall, for the moderate price response case, every dollar spent on DISC increases Federal tax revenues by $1.24. Thus, repeal of DISC would reduce Treasury revenues rather than increase them.

A. Cost/Benefit Assessment

Section III established that DISC would stimulate additional exports valued between $1.5 and $7.0 billion in DISC year 1979. According to Treasury, these additional exports are realized at an initial cost in revenues foregone of $994 million.[33] However, as suggested in Section IV, the DISC induced exports generate additional Federal tax revenues. For example, $5.3 billion in DISC induced exports (the moderate price response case) will generate the following additional Federal tax revenues:

---

[33] This figure includes the foregone taxes on DISC deferred income from the induced exports. A correct revenues foregone calculation would net out tax losses on the induced component. For example, the true cost in the moderate case would be $833 million ($994 million less $161 million; that is, the revenue loss associated with the $94.3 billion of DISC sales that would have existed in the absence of DISC).

	Revenue Feedbacks ($ in millions)
Corporate Income Taxes	$ 161
Personal Income Taxes	451
Payroll Taxes	420
Total	$1,032

As a result of the feedbacks, DISC generates more in revenues than its initial costs to Taxpayers. For example, in the moderate case, the initial revenue loss of $833 million[34] is more than offset by the $1,032 million generated from the three major taxes on a portion of income from DISC induced exports. In this case, repeal of DISC would not only reduce exports by $5.3 billion but would also cost the Treasury $199 million in net tax collections.[35]

There are several reasons why these changes in net tax collections may be considered conservative. First, the net revenue loss from eliminating DISC reflects only a few of the more obvious feedbacks. For example, revenues associated with DISC-induced income to suppliers were not included in the calculation. Second, only revenue impacts were considered in the partial feedback analysis. If DISC were repealed, the implied reductions in output could lead to increases in Federal outlays for various welfare programs as well as increases in unemployment benefits.

---

[34] After adjusting for revenue losses on DISC induced exports. See previous footnote.

[35] These revenue loss figures depend upon the assumption that resources used in the production of DISC-induced exports were previously unemployed and that the export increase represents a net increase in the U.S. balance of trade.

Finally, the calculations only consider the initial feedbacks caused by the DISC induced exports. However, in subsequent rounds the feedbacks may be multiplied and result in additional revenue losses from the repeal of DISC. These feedbacks are difficult to quantify. However, a recent study of subsidies implicit in Federal Eximbank loans suggests that the ripple effects through the economy would more than double the initial output effect of DISC.[36] Thus, this additional output would lead to additional tax collections.

B. Repeal of DISC with ACRS

Treasury's most recent revenue loss estimates for DISC do not include the effects of ACRS. In general, ACRS reduces the effective tax rate on the corporate sector and there is no reason to expect this effect to be disproportional between production for domestic consumption and production for export. Since ACRS will reduce the amount of income that can be deferred from taxation through DISC, it will reduce the revenue losses associated with the DISC deferral. While total exports may not change under ACRS, estimates of DISC-induced exports will decline because of the smaller DISC price effect with the presence of ACRS.

---

36. It was found that the ratio of change in the Gross National Product to the expenditure subsidized by the Eximbank was 2.2 over the life of the project. See Wharton, EFA, Inc., "Budd Company and Westinghouse Electric Corporation Buenos Aires Subway Car Contract: Net Impact on the Government of Export-Import Bank Financing," 1981.

The U.S. Treasury suggests that with ACRS, DISC costs and induced exports would decline proportionally. Treasury estimates that ACRS would reduce both DISC costs and induced exports by 27 percent.[37]

Using the Treasury figures on the impacts of ACRS, the previously stated conclusions regarding the cost/benefit implication of repealing DISC would not change. For example, after ACRS the Treasury revenue loss estimate for DISC would decline to $608 million (73 percent of $833 million) and DISC-induced exports in the moderate price responsive scenario would decline to $3.9 billion. This new level of DISC-induced exports would result in the following tax collections:

	Revenue Feedbacks ($ in millions)
Corporate Income Taxes	$118
Personal Income Taxes	329
Payroll Taxes	307
Total	$754

Post-ACRS, repeal of DISC would reduce revenue collections by $146 million in DISC year 1979 rather than the previously stated amount of $199 million revenue loss before considering the effects of ACRS. While ACRS erodes some of the net revenue benefits of DISC, after ACRS DISC still provides a net benefit; that is, for every dollar of tax expenditure for DISC, Treasury collects $1.24 in addition taxes on profits, wages, and salaries.

---

[37] "Export Tax Incentives," Memorandum for Secretary Regan from Norman Ture, Under Secretary for Tax and Economic Affairs, October 28, 1981.

Once again, these figures are conservative in that they do not reflect outlay impacts as well as multiple feedbacks from the ripple effect on the economy.

C. Conclusions

The quantitive assessment of the costs and benefits of DISC presented in this study suggest that exports would decrease significantly with the repeal of DISC, while Treasury receipts would not rise. This finding remains true even when the effects of ACRS are considered. These findings should be considered suggestive rather than predictive since they are based upon a partial feedback analysis. This partial feedback analysis required simplifying assumptions for purposes of quantification and did not quantify numerous other feedbacks that may augment or diminish the final result.

Mr. **Nowak**. Just for clarification, what broader kind of material would lead to a more definitive decision on the question of the Treasury shortfall, or revenue, if DISC were eliminated? I mean, how close are you to the actual figure? Can you give me a percentage as to how far you would go either way if you had the time and the contract to do so?

Mr. **Korbel**. We believe that there is a large degree of uncertainty in this area. With any tax measure, and any tax incentive, there are numerous assumptions that have to be made, in order to estimate the impacts. We looked at one set of uncertainty when we dealt with the responsiveness of markets to the DISC incentive. We measured this responsiveness through a traditional price elasticity approach, and we looked at various elasticities that were available in the literature.

Based upon the uncertainty in the literature, we developed a range for market responses. We believe that the result is within that range, but it is difficult to pinpoint any particular point within the range. The only way to get a definitive answer on the impacts of DISC is to build a very comprehensive, general equilibrium model, which would account for the DISC a very disaggregated way for the United States, and would also account for the behavior of our trading partners in response to DISC.

We think that this in impractical, and we certainly did not advise our clients to fund such a study. We believe that our study has performed a vital function in being vaguely right, rather than precisely wrong.

Mr. **Nowak**. Your clients must have had some reaction to the study when you presented it. Could you give us their comments on the study?

Mr. **Korbel**. Well, I feel overall, their reaction was favorable to the study, and they support our findings. I think they would like to have seen DISC have a greater benefit, and they would like to have seen us narrow down the range of uncertainty regarding the impact of DISC on the world markets, but they understood that it is an imprecise area, and thus, they were satisfied with the degree of precision that we could give.

Mr. **Nowak**. Am I right in assuming that your $1.24 estimate in additional revenues, did not take into account the loss of additional revenues that would have been paid out in such programs as unemployment insurance and so forth?

That would be an additional factor, totally apart from the $1.24. It would be a plus, I assume, for the program, if you took the unemployment figures that would result, and multiplied those out by unemployment compensation, food stamps, and everything else, forgetting about the social implications. I don't want you to go that far. Is that correct?

Mr. **Korbel**. I think that is true. Dr. Hoffman, would you like to comment on that?

Mr. **Hoffman**. Well, in particular, our study focused on tax receipts of the U.S. Treasury, and some of the outlay benefits, of course, that you are talking about would accrue to Federal, State, and local governments.

So, as you indicated, it would increase the net benefit of DISC if you expanded the scope to include expenditures by Federal, State, and local government.

Mr. KORBEL. It would be possible to estimate the impact on unemployment compensation by translating the output effects of DISC into the effects on the level of unemployment: In other words, the change in the number of jobs that are generated by DISC-induced exports. One could make some assumptions about the probability of these individuals receiving unemployment, and translate that into a measure of the outlay effect of DISC.

By not considering the effect of DISC on outlays, we were trying to be conservative in our estimates, and pinpoint three major taxes which were obvious and noncontroversial to most reasonable analysts.

Mr. NOWAK. Your clients haven't proposed any studies of proposed legislation that is in the Senate or in the House now, regarding this DISC problem?

Mr. KORBEL. To the best of our knowledge, no.

Mr. NOWAK. Well, I will suggest it, but I think, some type of detailed study will have to be made for any modification that we are going to go through here. We are going to have to have some estimate, like this study that you undertook was for Treasury, to give them guidance in their response to the initiatives that are coming from our State Department, and other problem areas.

Mr. Marriott, do you have a question that you would like to ask at this time?

Mr. MARRIOTT. Thank you, Mr. Chairman.

I appreciated your testimony. It was very good and very well done. I think every Member of the House ought to read it. I am going to put it in the record, if that is all right with you, so they can have that opportunity, because I think you make some very good points.

Let me read a statement. Later on, Haskins and Sells will be here, and they will make a comment. Part of that is going to focus on the conclusion they make, and I believe it, I want to ask if your study addresses it, and whether or not you agree. It centers around the idea that if 1 tax credit is good, then 10 are even better, and maybe we ought to centralize our thoughts on providing more incentive for exporters. I think we are very weak in that area, notwithstanding DISC.

Here is what they say:

> DISC can be a meaningful tax benefit to businesses that use it. However, it is not a motivating factor in the decision of the small business to export, because its benefits are long term, and do not compensate for the initial high cost of market entry in the short term.
>
> Furthermore, DISC is too complex and restrictive. It does not allow small business to properly understand its benefits and consequences, or utilize it without significant cost.

Now, that has always sort of been my feeling about DISC. You indicate that we are really getting $1.24 for every dollar that we lose on the deal. But, isn't it true that most businesses know little about it; that it is not a motivating factor for small businesses to be in the export business? I have always felt that a tax deferral is wonderful, but it doesn't go far enough; so, should we provide some additional tax incentives that could substantially help our balance of trade, and in fact enhance our Federal coffers as well?

Could you give us your comments on those questions? There are two or three in there, but does your study address any of that?

Mr. **Korbel.** The short answer is no. We basically deal with DISC in the aggregate. We do not distinguish between types of firms that may be affected; the marginal firm may have an incentive to invest or not invest in a DISC-related activity. So, therefore, we do not address that issue head-on. We do, in providing an aggregate measure, that for every dollar spent the Treasury gets back $1.24, indicate the positive benefit of such a subsidy, and one could conceive or construe from our results that dollars spent on such a subsidy would be beneficial, and therefore, further investment in such an activity would be beneficial.

Mr. Shapiro, would you care to add anything on that in terms of the incentives for smaller businesses?

Mr. **Marriott.** You don't address what might be done to improve it or to further enhance revenues?

Mr. **Korbel.** We do not. We were not asked to develop policy. We were simply asked to evaluate the economic impacts of——

Mr. **Marriott.** I understand that, but in the doing, you did not arrive at any other conclusions in terms of how to even make this a better situation. That was not part of your study, I understand. I am just wondering if you took it on yourselves to go the extra mile.

Mr. **Nowak.** If you have a personal opinion as to that question.

Mr. **Korbel.** I am not in a position to offer a personal opinion on how to improve the DISC. Perhaps Mr. Shapiro, our national director of tax policy, could speak more fully for Price Waterhouse in this regard.

Mr. **Shapiro.** As indicated, this study clearly is an economic study with statistical data to support its conclusions, and therefore, was done by our economic staff. It did not have a focus on any tax policy implications.

Let me make a few comments about my personal involvement. I was on the joint committee staff in 1971 when DISC was enacted. When DISC was proposed, it came in under the emergency economic Treasury measures that were made on August 15, 1971. At that time the joint committee staff had a great deal of concern about the appropriateness of DISC and whether or not it would result in increasing exports as advertised.

The DISC proposal was held up for quite a while in somewhat of a stalemate between the Ways and Means Committee and the Treasury. A great deal of concern was expressed at that time by Chairman Mills and other members of the committee with regard to how DISC would be received.

As you know, at that time there were closed sessions and markups, and there were lots of discussions in those closed sessions whether they should proceed with the DISC provisions. It wasn't a big business or small business issue, but whether or not DISC was a tax concept that should be implemented.

As you may recall, in 1971 Congress was presented with the proposal by the administration to reinstitute the investment credit. That gave a great deal of concern about tax incentives. It was not a tax policy initiative where you have a recovery of cost in the form of depreciation, rather a special writeoff. The investment credit had an interesting history. It was proposed in 1962; it was suspended in 1966; it was reinstituted in 1967; and repealed in 1969. In 1969, I remember specifically, Chairman Mills and other members told the Treasury that this was not a device that should be turned on and off again for business. He asked whether they were really serious about the repeal, or whether they were going to come back in 6 months and ask to put it back into law.

The response from the administration and the Treasury was "absolutely! We want to repeal the investment tax credit."

Then, in 1971, they came back to reinstitute the investment tax credit, making it permanent. The Treasury also proposed a new type of tax policy concept, which was the DISC. That gave a great deal of concern to many members. Was the administration proposing a DISC for a short-term solution? Put it on the books, have everybody elect DISC, and then regret it a short time later, following the investment tax credit experience.

After debating it for quite a while, with our unfavorable balance of payments then, the Ways and Means Committee and ultimately the Congress agreed to pass DISC.

From the day it was passed there was a great deal of apprehension in tax policy circles as to its effectiveness. Most of the big businesses adopted it quickly. Small businesses were a little slower to adopt it. It was not as complicated as today, but still, it was involved, and required them to get an analysis.

Small business didn't have the people consulting them that could pursue it, when it was new. I think it is probably fair to say that not as many small businesses adopted it as the bigger businesses at the early stage.

From the beginning, any time tax reform was considered as a topic for congressional consideration, DISC was at the top of the list as one of the items to be considered for repeal. Even later Treasury Departments were focusing on it.

Ultimately, Congress went to an incremental DISC. There was the concern that DISC was a windfall, giving companies something for which they were doing anyway. The result was an incremental DISC, which stipulates that you may only benefit from DISC to the extent you increase exports.

A lot of us focus on the effect on small business, and the special rules that try to deal with it. But as you know, after you start fine tuning any provision and providing incremental effects, you increase the complexity. As you start providing rules to deal with this situation, and that situation, and who can have a DISC, and focus a certain type of activities which are not permitted to even have DISC's, it gets complicated. As a result, I think the complexities continue to grow.

I think it is fair to say right now about the incremental DISC's, that many feel it is working better than before, because it shows that you qualify only when you increase exports—although DISC is still a question for consideration.

With regard to small business, I think that your assumptions, and I think that the statement that was in the H&S report that you referred to, is accurate. It makes conclusions in that respect that I think have a general perception. As to what to do with DISC to make it more responsive to small business is not easy to relate to, especially since DISC is under attack as a general concept from GATT. Many propose that we should repeal DISC because it violates GATT; that has always been a concern within the State Department. Conflicts are evident between the State Department and the Treasury Department; and the question is should we create a FISC, a Foreign Investment Sales Corporation, get it offshore, so we don't have GATT problems.

I think it is fair to say that the major focus of DISC has been to the broad context and not specifically to small business, although I think the Congress has been aware of some of those concerns in some of its deliberations.

Mr. MARRIOTT. Well, I appreciate that comment, and I think that is a very good statement. Let me just conclude by asking this: Your study deals with mostly big business, doesn't it? In other words, the cost-benefit ratio is basically because DISC's are being used by large business.

Is that fair to say?

Mr. KORBEL. Our study is based upon the DISC year 1979.

Mr. MARRIOTT. I know.

Mr. KORBEL. It is the entire data for the companies filing for DISC.

Mr. MARRIOTT. But did you break that down to how much of that is small business related?

Mr. KORBEL. The Treasury——

Mr. MARRIOTT. Or, did you just deal with the aggregate?

Mr. KORBEL. We just dealt with the aggregate in terms of business size. However, we did break it down according to industry area, for purposes of market response.

Mr. MARRIOTT. Could you have broken it down to show the small businesses who participate in it, to show us what the economic impact is to the small businesses in DISC?

Mr. KORBEL. We did not have the market response information by size of business, and by industrial area: That is, agricultural, nonagricultural, manufacturing, et cetera for which we had elasticity estimates. It would be possible, however, in a very rough way, to break it out for smaller business by looking at something such as gross receipts by size of DISC, which are in the Treasury report. But that was simply not the focus of our analysis.

Mr. MARRIOTT. Mr. Chairman, I again applaud this committee for holding the hearings and for this study which has been done. I think it does prove that tax incentives of this type are good for the country. We ought to do even more of it as we try to reduce our balance-of-trade deficit.

But I would like to see if there were some way we might figure out how to expand this study, so that we could understand what the small business situation is. I think the effects of DISC on small business or vice versa are somewhat distorted because of the impact of the bigger companies who are involved in it.

I would like to see if we could break that out so we can get an idea of whether or not this is really a profitable venture for small businesses as well.

I thank you.

Mr. **Nowak**. We have received the gross receipts for DISC's in the year 1979, and we do have the size of the gross receipts from under $50,000 to over $100 million, and that is broken down into the total dollar volume. It would be an interesting study to go to the three lower categories, that is a million and under, and try to have Treasury conduct such a survey through the offices of Price Waterhouse to see if the impacts remain the same. We could see if there are not even heavier impacts on the breakout of the smaller sized businesses, because, especially in considering ACRS and some of the others, they are probably not going to be as capital intensive.

So, the impact down the road of this so-called subsidy may be heavier on the smaller firms than it would be even on the larger firms. I think when we are through with our hearing, we can both make that kind of suggestion to Treasury, and see if we can't get those kinds of analysis done, because I think it would clearly prove that there may be heavier impacts in the small business area.

Mr. **Marriott**. Mr. Chairman, my reason for that is not just to have more studies done; but, we had cases that were alluded to in earlier testimony today where we have small businessmen in my State who have lost good foreign contracts because first, they didn't have the capitalization to do it; second, the local banks knew nothing about the foreign market, and third, DISC's just didn't seem to be the immediate answer.

What I am trying to do is improve small businesses' share of exports. But, I think we need to know whether the DISC is doing it, whether some modification of DISC, or whether some different program altogether ought to be initiated to help small business. So that is the reason that I am trying to get some additional insight into how effective these DISC's are for the small guy.

Mr. **Korbel**. Mr. Chairman, we have had the opportunity, during the course of this study, to work closely with Treasury in reviewing our current report on DISC, and we would welcome the opportunity to do further work in terms of looking at small businesses.

The data are clearly available. The DISC 1979 study is based on a sample of DISC returns, which they have information on the size of the DISC, and the type of industry. With some statistical work done by Treasury, we could very easily, I think, analyze these data.

Mr. **Nowak**. You know, it is amazing the difference in analyzing those gross receipts for 1979 to see the tremendous dollar volume done by the large corporations, and the very small volume done by the under $50,000 and the $50,000 to $250,000. So I think it would be a worthwhile study. At least, it would give us an idea if those few that are participating are getting a benefit out of it.

Somehow, perhaps, as Mr. Marriott suggests, we could put something into the new modifications which would give some greater emphasis and desirability on participation by the small- and medium-sized corporations.

We will be back to you with some questions about how we define that and certainly, we will be working with Mr. Marriott to bring that to the attention of Treasury. Again, let me thank you for your appearance here today, and we want to thank you for taking the time of three very expert people in this area, for the benefit of this committee.

Thank you very much.

Mr. **Korbel**. Thank you, Mr. Chairman.

Mr. **Nowak**. We will now adjourn until 2 p.m.

[Whereupon, at 12:23 p.m., the subcommittee recessed, to reconvene at 2 p.m., the same day.]

AFTERNOON SESSION

Mr. **Nowak**. The subcommittee will come to order.

We would like to continue with our afternoon witnesses. The first will be Thomas M. Rees, a former Member of Congress, and highly respected. He is an attorney now in private practice in Washington, D.C. He is a specialist in international trade. He is a former chairman of the House Banking Subcommittee on International Trade, Investment and Monetary Policy. I know that his opinions were not only respected in the House when he was here, but even more so since he became an expert in the private sector.

Tom, would you come forward.

TESTIMONY OF THOMAS M. REES, ATTORNEY, WASHINGTON, D.C., AND FORMER CHAIRMAN, SUBCOMMITTEE ON INTERNATIONAL TRADE, INVESTMENT, AND MONETARY POLICY, COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS, U.S. HOUSE OF REPRESENTATIVES

Mr. **Rees**. Thank you very much, Mr. Chairman. It is a pleasure to be here. I haven't been up to the Hill now for about 4 months, and I feel guilty when I read the newspapers and find out what you have been going through.

Mr. **Nowak**. You really haven't missed much, Tom.

Mr. **Rees**. That is what everyone tells me now that my step is lighter and I am smiling a lot more.

I appreciate the kind invitation of the committee to testify. I am particularly interested in the field of small business because I am a small businessman myself. I started out originally as an exporter. I was the founder, president, secretary, and everything else of Compania del Pacifico, Inc. in Los Angeles. I dealt basically with northwest Mexico, exporting farm machinery and parts.

I found that when I was elected to Congress, it was very difficult to run the business, so I closed it out. Now that I am out of Congress, I am very happy to say that I have formed another export trading company by the name of American International Trading Group. It is a very fancy name, but it is essentially a small business. There are about four of us in it, and we are dealing basically with Southeast Asia.

I am also a member of the Washington-Baltimore District Export Council. We advise the Secretary of Commerce regarding what we feel should be done in the area of international trade.

Several years ago, I was appointed by President Carter to head up a task force on small business and international trade. This was part of that White House Small Business Conference. I am very leery about any kind of White House conference because usually it is merely a press event for whomever is occupying the White House. But I accepted the appointment because I felt that we should try to find where small- and medium-sized businesses might be in the whole scheme of international trade.

We had a task formed solely by those actually in the field. They were hands-on people; they weren't professors or consultants or anything like that. Members were exporters, bankers, and freight forwarders.

We came up with a whole series of recommendations which we made to the White House Conference. The White House Conference didn't take all of the recommendations to heart, but they did take many of them. Part of the problem is they always want to take the "massaging" recommendations, but they don't want to take any recommendations that affect tax incentives more liberal lending policies of the Eximbank or anything that might show up in the OMB Federal expenditures.

I would like to give our report to the the committee because it is an effort of medium and small businessmen in the field of international trade to try to come up with realistic proposals.

When I was on the Banking Committee, I was chairman of the Subcommittee on International Trade, Investment and Monetary Policy, and our primary jurisdiction was the Eximbank, and we also dealt with the IFI's, the international financial institutions, such as the IMF and the World Bank.

It is always difficult to discuss international trade because everyone is looking for an instant solution. One of the reasons the United States is not that engaged in international trade, in terms of the full use of its resources, is that we have never had to trade to exist. We are very fortunate to have a country that is continent size. We have, by far, the largest GNP of any nation in the world. It is a multitrillion-dollar market. Every country in the world is breaking their tail to come into our market.

We are not doing too much to get into other markets in contrast to Japan, for example, or the United Kingdom or the Netherlands. We were blessed with resources, so we didn't necessarily have to trade to keep the economy going. We didn't have to worry about oil; we didn't have to worry about energy; we didn't have to worry about ferrous and nonferrous metals, because we had them; and we certainly didn't have to worry about food. As a result, the pattern of trading in the United States is really tied up with the largest American multinational corporations. This is part of their function, because they have a world market. So you find that Standard Oil of California or IBM or Ford are all trading companies, and they have been doing this for a long, long time.

In the area of food exports, I don't think there is a country that does it better. Most of our trading companies, such as Continental Grain, are huge companies and are privately owned, and there is nobody that knows markets the way they do. A major trading company in minerals is Engelhard. There was a split at Engelhard. I think that Phillip Brothers was spun off. Phillip Brothers is the most fantastic trading company I have ever seen. When I was in Congress, I went up to New York to watch them. They deal in all ferrous and nonferrous minerals, and they turn deals around like nothing I have ever seen. It is beautiful.

But, again, these are very large companies. We don't have a lot of export companies that deal with general merchandise, that deal with manufactured goods, because this is concentrated mostly with the very large multinationals.

We have a lot of export companies. I was an exporter, and I have an export company now. These companies primarily function as export managers. They are relatively small. If you find one that does $50 million worth of business a year, it is a pretty big company.

Congress is now considering a bill that would create export trading companies. Everyone is putting out their press releases stating that this bill is going to solve our trade problem. I am very familiar with the bill. About all the bill does is allow banks to own export trading companies, which really is nothing to celebrate as export traders and bankers are two very opposite and distinct people. Usually an export trader is a risk taker. This is a person who takes risk, and it is the complete antithesis of a banker. I found that out having been a small businessman trying to get bankers to finance my exports. It was extremely difficult. They will do it on an irrevocable letter of credit, but irrevocable letters of credit are not what you call swinging finance in the international area. I don't know what the bill is going to do, but already there are those claiming that we are going to change our balance of payments with this bill.

Originally the bill contained a lot of other things that would directly affect the bottom line, and they were cut out because they had budgetary impacts. There were proposed amendments to DISC. They were knocked out. They were going to propose a window at Eximbank to finance smaller exports, and that was knocked out. Just about everything that would have helped the bottom line of a small export company was knocked out of the bill. So now everyone is for the bill, including the OMB, because it is not going to cost the Federal Government a nickel; for $50, I can form an export trading company. All it takes is a filing with the corporate commissioner and get your corporate seal and your corporate books, and you are an export trader. There is nothing mysterious about an export trading company. Unfortunately, we find that not much is being done for exports.

I might say, in looking at the business we have in AITG, that if we had anything to say to Congress it might be, "Get the Government off our tail." I don't know of a country that shackles the small and medium exporters in being able to reach international markets as we do.

I can give you a few examples. The Eximbank is full of restrictions. I tried to knock them out when I was chairman of the subcommittee, but they have to deal with boycotts and trade with Communist countries or countries that have reneged on a debt. There are restrictions on the Eximbank of who you can and cannot lend to. Generally, the bank likes large loans; generally, small businesses want small loans. The Eximbank considers a $4 million loan to be a small loan. As an exporter, I would say that a revolving $½ million line of credit would be the most wonderful thing I could have.

The Export Administration Act will tell the businessman what he can and cannot export. The President, by decree, can rule that there is an embargo on products. We are going through this right now with the pipeline in the Soviet Union. While we are breaking our tail to ship more wheat to the Soviet Union so we can get more of their very scarce dollar credits, we are putting restrictions against American companies that would want to build a pipeline. I can't see the difference of how building a pipeline is terrible, but selling wheat is good, because they are all taking scarce Soviet dollar credits. But you find that American companies that have been negotiating on this pipeline for the past 6 or 7 years now find that they are shackled and they can't export this equipment for that project. About a month ago one of my clients was held up on an export license to export road construction trucks to Libya. I don't like Libya, and I don't like Quaddafi, but if I don't like a country's current policy, it does not mean I shouldn't do business with them. Quaddafi might not be here tomorrow or the policy of the country might change. We have seen this with Algeria. Algeria has changed in the last 5 years, in terms of where their mix of business is, and where their dependency of markets are.

It took us about 2 months to track this Libyan export license, and we finally found it and were able to expedite it. There was no restriction against the license per se. There was no restriction on selling trucks to Libya. But because it was Libya, Commerce dragged their feet. It was very difficult for my small businessman exporter because he was exporting to a Dutch company that was one of his prime customers, and the Dutchman said:

> Look, if you can't get me this type of a truck, I don't know if I want to do business with you, because I prefer doing business with a company that doesn't have all of these restrictions.

Look what happened when they put on the wheat embargo. All they did was give the wheat farmer a kick in the tail because, of course, the Soviet Union went to Argentina to buy their wheat.

When I was in Congress, President Nixon put a restriction on soybeans, logs, and scrap metal to Japan because, at that time there was a shortage in the United States. The domestic people said, "Gee, we need more timber for building houses and we need more soybeans for our industry." What happened is the Japanese went to Brazil, and now Brazil is the second largest producer of soybeans in the world, and we lost an export market. It was the same thing in lumber and scrap.

We find that foreign buyers cannot understand how we get our foreign policy tied up with foreign trade every time there is some disagreement. It makes it very difficult if you have to go to your client where you have a firm supply contract and say, "Gee, I am sorry, the President is very unhappy about what is happening in Southeast Asia or Europe, and I can't export those goods to you." You know that person is going to find an alternate supply. It makes it very difficult with the restrictions that we have on people who want to export.

Generally, small and medium businessmen aren't that hot to export because they have the domestic market. Why deal with a foreign market when you can deal with a market in the United States. You are only dealing with one currency, the dollar; you are dealing with a banking system you can trust; you are dealing with a country that has laws and has uniformity and has the 14th amendment. If you go overseas to do business, it is tough. I love foreign trade, but it is tough. You never know when a currency or a government is going to go up or come down.

One of my clients—I guess I better put it in the past tense—was one of the major Mexican banks. I don't know if my client, the president of the bank, is still really the president in fact, or if he is not. I don't know what is going to happen to their banking assets in the United States. This doesn't happen here, but it does happen overseas. I considered Mexico to be a very good and firm basic market. There the businessman asks, "Why go overseas when he has a good domestic market."

I think the essence of the Trading Company Act is good because it might educate people to the fact there is such a thing called an export trading company. Banks feel restricted because they are restricted. Bankers can only do what we tell them they can do under the statutes. The biggest battles we always had in the Banking and Currency Committee were on the Bank Holding Company Act because this act defines what a bank can and cannot do. If it is restricted in the Bank Holding Company Act, the banks want to do it. I suspect if you told them that you were going to put in an amendment to allow banks to own massage parlors, they would probably all go out and try to buy massage parlors.

They are all looking at export trading companies. This bill will focus some attention by bankers on the possibility of dealing with export trading companies which might service small and medium business. It is the understanding by a bank of the business of foreign trade that will cause them perhaps to put more credit out for foreign trade. That is the one salient point in the bill. We hope that, if the bill is passed, it is going to give us opportunities.

Right now, AITG is working on several joint venture companies, such as a holding company that will sell shares to several major regional banks. We hope to put several export management companies within that framework, and maybe one or two foreign banks. Usually, foreign banks don't have restrictions like we do, and a lot of foreign banks have experience in international trade that American banks don't have.

We hope that, with this type of structure, we will be able to have a fairly comprehensive company that can really serve overseas markets and also knows their product lines in the United States. This is part of the problem. Exporting is a specialized field, and you need to know your product because you have to service it, you have to explain it, and you have to sell it. You also have to know your market. When someone comes up and says, "I have A B C Export Co. and I can export to any part of the world," hold back. We deal in a very stable market, in Southeast Asia. Even in a stable market, we find that every country is unique and you really have to know it in order to make sales.

Something that bothers me is the OMB. Of course, this is nothing new and I am not criticizing any administration. When I was chairman of the committee dealing with Eximbank, Eximbank credits and direct lendings were not under the unified budget. Unfortunately when I left, they were put under the budget. This makes it very difficult to adequately finance through the Eximbank.

You have to remember that if you appropriate money, say, for an airplane, you spend the money on the airplane and that is it, and you don't see the money again. If you are a bank and you are lending money, you take back an asset called an account receivable. So it is really not an expenditure; it is a loan. There are a lot of people that don't know the difference between an asset and a liability. I know Senator Heinz is working on this. There might be some way to pull a lot of the lending and a lot of the guarantee programs out from under the budget. You could go into it and set up loan-loss ratios, to control the appropriations, and then appropriate that part. But I think it is very difficult the way it is constituted now because they keep cutting the Eximbank at a time when we should be lending more money.

I think also there needs to be a special window at the Eximbank that can deal with small- and medium-sized business. They only have one office over here on Vermont Avenue. You take an exporter from Buffalo or Los Angeles or Des Moines, and they can't afford to come here to get an Eximbank loan, or a briefing by Eximbank to find out what is going on.

What we were thinking of in forming these joint venture trading companies, is that the trading itself might go to the Eximbank and get a line of credit for $3 million, revolving and with that be able to service the smaller manufacturers who want to penetrate a market.

I would like to discuss DISC. Since you have been having hearings, you are very well familiar with the purpose of DISC. What DISC will do is defer taxes on export income. I think that the way the law is now, one half of your export income is deferrable. This has to be covered by 95 percent of export receipts.

So you have a corporation which is a DISC corporation, a paper corporation, and each year you have been deferring based on your export receipts. So you have a considerable amount of money say, $1 million, on your DISC account, you don't have to pay taxes on that. You can use your DISC money for a lot of purposes. It has to remain DISC money, though. The minute it is repatriated back to the corporation itself, you then have to pay taxes.

Part of the problem with DISC is it is extremely complex. When the IRS comes into your shop and looks at your books and looks at your DISC, and then the IRS says they don't recognize some receipts as export receipts, and you are not up to 95 percent, you are only at 94 percent, the Internal Revenue Code says everything in your DISC then is a deemed distribution.

Let's take the example I gave you. The person has a million dollars in DISC. That is an accumulation of 10 years. He misses his 95 percent deemed distribution by 1 percentage point. All of that million dollars is then a deemed distribution, and they have to pay a 50-percent tax on that. Until the tax reform bill that was passed last year was passed, that deemed distribution tax rate would be 70 percent. If you have an active DISC where the money is moving around, if you come up with a 50 percent deemed distribution, this could very well put you under Chapter 11. It is a very tough penalty for missing 1 year by 1 percent.

I drafted up some amendments to this which would change the deemed distribution formula to say that you just take the penalty on that year and not your entire DISC.

I think the major problem with DISC, though, is that it is extremely complex, and the criteria for accounting is very complex. It means that the small and medium business will not go into a DISC because of the complexities.

I am a partner in a California law firm, and our major office is in San Jose, which is the capital of high technology in the computer sciences. I asked the partner of one of the big five accounting firms why merchants didn't use DISC, and he said, that DISC was so complex, by the time you finished forming the DISC it costs you more money in legal and accounting fees than it does from the benefits of the deferrals.

I was on a U.S. Chamber task force a couple of years ago on small business and trade. The chairman of our task force is the president of a high technology company over in McLean. He had about $50,000 in his DISC and he was having problems with the IRS. He went to his attorney and his accounting firm, and the billing for getting his DISC back in shape was $30,000. Not many small businessmen can afford this type of problem. If we are to retain DISC, I think something needs to be done to simplify the accounting rules.

One thing you could do is you could more or less assume that the first million dollars a year is OK under certain restrictions, so that they take their automatic deferral on 50 percent of that, and they don't get the tough audit. If they go above that, then they would go through the tough audit. The major recipients of this today are the Fortune 500 corporations. I would say they probably take 80 or 90 percent desk deferrals of that. Part of the reason is they can afford to have a floor full of accountants.

Here is the larger problem with DISC. We are a member of GATT. GATT states that there cannot be any direct subsidies of exports. So if you set up a specific program to aid exports such as a DISC corporation, this is in violation of GATT. I suspect the way the negotiations have been going, GATT will be getting tougher and tougher with the United States regarding our DISC's. It is not that DISC really stimulates exports that much in terms of actual dollars, but it is something the United States is doing specifically for exporters. So I would assume that DISC is going to go by the board, and I don't know what is going to replace the DISC.

The major problem is national tax policy. You will find that most countries will tax the income of people who earn money within that country. If an American earns money in France, he pays French income taxes and takes a tax credit on his U.S. form. If a Frenchman earns money in the United States, that money is not taxed by France until it is repatriated back to France. Most countries do not tax the income of their own citizens, and overseas subsidiaries of their domestic companies until that money comes back.

The United States, though, taxes everything. We tax the income of our citizens if they make money in the United States. We tax the income of foreigners who make money in the United States, but we also tax the income of Americans who make money abroad.

Now, if we developed a tax policy which said we tax the income of all people making money in the United States and that is all exempting foreign income until expatriated, then there wouldn't be any problems. But I don't think we are going to do that any more since we are going to have a value-added tax in this country. A value-added tax is another subsidy in a way, because a French manufacturer who exports his goods gets that value-added-tax rebate when he exports it.

I remember we had a distinguished chairman of the Ways and Means Committee who just said that maybe we should take a look at value-added taxes, and he never came back. I doubt if the Congress or the Ways and Means Committee will start considering a value-added tax. It is a very difficult thing to do, because a value-added tax is a sales tax, and there is a lot of disagreement as to whether we should have a sales tax or an income tax.

I think we do need something because most of the countries that we export to, especially in Europe, have value-added taxes.

It is fine to read the legislation like the Trading Company Act, but there has got to be something that shows up on the bottom line. There has to be more protection for the small and medium export trading company and the small and medium manufacturer. You could sell something in yen, and you could have a 10 percent movement of the yen against the dollar and you are out of business. Just remember that in an export transaction you might only have a 5-percent override. It is none of this 40-percent profit. There is a lot of competition there. You are dealing in fairly large deals. I think 5 percent is reasonable if you take a 10-percent change between the yen and the dollar without any type of currency movement insurance, and you are in trouble.

I think that probably what we need to do for small business to develop is some programs where they can have currency fluctuation protection, if we don't have these programs for small business.

One of the recommendations from the White House conference was that we ought to have a one-stop service. There are various Federal agencies dealing with exports. I always go to the IRS before I do anything. I don't want to do something and then have the auditor sitting in my office. It is not that they found anything, but it just takes a lot of your time. You have to pay your accountant to be audited and, if they find that you are OK, they don't reimburse you for expenses. If you are dealing with 901 and 903 in tax credits or 911 and your employee is overseas, it is very complex.

They ought to take the IRS, the Department of Commerce that has three or four agencies within the Department to deal with export, the Eximbank that only has one office which is here in the District of Columbia, the Department of Justice in case they have a problem with antitrust, and put them in one room and say, "OK, you are the one-stop service." When a person walks in, he has everything there and he is not running all over southern California or northern New York trying to find out how to put together a transaction.

One of the things that we thought was very good was MASSPORT, the Massachusetts Port Authority. They decided that they need an agency that will walk the exporter through a deal. The Department of Commerce gives you brochures. All these agencies give you brochures, but they don't tell you much. You might have a good person in Commerce, but you might have a dog who doesn't know anything and is just waiting on his retirement. I found that in many cases the information from Commerce is dated. They were going to have a system called the WITS to give you up-to-date information, but it never did get off the ground.

What MASSPORT did—an agency of the State of Massachusetts—was they would take a potential exporter, after he got the Department of Commerce brochures, and say:

> OK, if we choose your company, if we think you have a good product and you have good potential overseas, we are going to walk you through that deal. We are going to tell you exactly what we think the marketability is. We are going to tell you where we think you can sell it. We are going to tell you all about value-added taxes and how they affect you. We are going to tell you all about restrictions in the country you want to export to. We are going to tell you all about letters of credit and sight drafts. We are going to tell you about all the U.S. licensing. We are going to tell you all about your export packaging. We are going to tell you about freight rates, both for airplane and ship, and we are going to loan you the money, interest free, to get you overseas to London, and our MASSPORT representative is going to meet you there. He is going to have a schedule and he is going to walk you through the deal.

It was very successful.

Supposedly, Commerce is starting to finance this type of program for local agencies and companies, which was one of the recommendations of our task force. I understand that about 15 grants will be given out in the next few weeks.

But if we had this type of enlightened program, such as they have as MASSPORT, if they can create this type of interest, I know that you are going to get small business in. But it has to be a one-on-one relationship. It has to be coming in and walking the person through a transaction.

The best way for me to work as an export trader is to say, "OK, you put your shipment on the dock, I will hand you the money and do everything else." If you do that, I think you can get people to export. But you must have the exporters go out and sell. You are going to have to have a certain economy of scale so that they can cover international markets. These are some of the things that we are working with at AITG to try to figure out how you can build a large company without spending a lot of money, by putting together various elements of banks and existing traders and, in doing this framework, be able to cover 30 percent of the world's markets.

As I said before, the one thing we have to do is figure out how to get the Government off our tail on a lot of these transactions. All you need to do is have someone turn down your license or delay it for 6 months and you are out of business. We need someone to make the transactions simple.

I want to thank you very much for your attention. I would be glad to answer any questions you might have.

[The White House Conference on Small Business option paper referred to above follows:]

THE WHITE HOUSE
CONFERENCE ON SMALL BUSINESS

OPTION PAPER

INTERNATIONAL TRADE

PREFACE

This paper is one of a series prepared for the White House Conference on Small Business. Along with others, it reflects major issues raised by over 35,000 small business owners who attended 57 field conferences, held in every state. A special task force of business men and women reviewed these issues, and have suggested a number of options that might enhance the interests of small business in each issue area.

Nothing in these papers should be considered recommendations by the Conference Staff, the White House, or any federal agency. Rather, the commentary, options and discussion are intended to identify for the Delegates to the Conference the major issues and suggestions that emerged from the field meetings and task force deliberations, and to provide a framework for discussion at the ten delegate regional caucuses to be held in October and November, 1979. Delegates attending these caucuses will help fashion the final issue agenda for the national meeting in Washington, January 14-17, 1980.

The Conference wishes to express great appreciation to the following members of the Task Force on International Trade, who gave unsparingly of their time and resources to this project.

Chair: Thomas M.Rees
Washington, D.C.

Commissioner: Tom Chan
Chicago, Illinois

Members: J. Hallam Dawson
San Francisco, California

Charles B. Dorf
New York, New York

Stanley Epstein
N. Hollywood, California

Marshall Frankel
Skokie, Illinois

Edward Gaffney
Waukesha, Wisconsin

Members: (Continued)	Rayton Gerald New York, New York
	Frank Ladue Sioux City, Iowa
	Nahum G. Shar New York, New York
	Maurice Sonnenberg New York, New York
	William Tobin Boston, Massachusetts
Professional Staff:	Christopher Brescia

INTRODUCTION

The U.S. trade figures for 1978 revealed a deficit of nearly $28.5 billion. Although the United States continues to be the world's largest exporter with over $143.6 billion in exports last year, this figure represents less than 7% of its GNP, the lowest percentage of any industrial nation (Japan - 12%; Germany - 23%).

Exporting has never really been a high priority in this country. The domestic market was large enough to satisfy the expansionist desires of the numerous growing industries during the 19th century. Raw materials were plentiful and what surpluses were generated were absorbed by other countries.

It was not until after World War II that the United States expanded its export sector for the primary purpose of utilizing the excess industrial capacity which was developed during the war. The U.S. share in world trade rose to 20% by 1951.

The large trade deficits the United States has experienced in recent years have weakened the value of the dollar, intensified inflationary pressures in our own economy, and heightened instability in the world economy. These trade deficits have been caused by a number of factors. A major cause has been our excessive reliance on imported oil. Another factor is that the United States economy has been growing at a stronger pace in recent years than the economies of our major trading partners. That has enabled us to purchase relatively more foreign goods while our trading partners have not been able to buy as much of our exports.

The relatively slow growth of American exports has also been an important factor in our trade deficit problem. Over the past 20 years, our exports have grown at only half the rate of other industrial nations and the United States has been losing its share of world markets.

At the present time, 1980 may be the year that the U.S. trade picture could take a turn for the better. Significant long range planning that includes greater participation by small business in exports could hold the key for a more stable and productive economy.

Small Business Participation

Although there are many reasons for the U.S. trade imbalance, part of the deficit may be attributable to the inability of many potential small exporters to successfully identify, develop, and market their goods, products and services to foreign markets.

In manufacturing alone, there are approximately 300,000 firms in the United States. Of this number, only about 25,000 export regularly and 85% of our total exports can be attributed to some 250 firms.

Low participation in exporting by small business is often attributable to an ill-conceived myth that only technology intensive goods with high value per pound can be successful in foreign markets. Market studies have documented the real need for consumer goods, many of which are produced in this country by small business.

Smaller firms tend to view world markets as the domain of larger firms which possess vast managerial and financial resources. Smaller firms feel that even if they did successfully penetrate foreign markets, their larger competitors would soon take these markets away from them.

However, buyers for foreign businesses and governments frequently discover that small exporters offer their products and services at prices lower, or on terms more competitive, than large businesses. Small firms have other abilities, which they often do not recognize, that can provide a significant competitive edge. First, they can serve the customer personally. Secondly, in fluctuating market conditions, the smaller firm has a shorter response time and can adapt much faster without spending inordinate time clearing multiple layers of bureaucracy. Third, smaller firms can serve smaller markets that are often too small to warrant penetration by a larger firm and are better served by the smaller exporter.

Yet, the Department of Commerce estimates that small business accounts for no more than 10% of the U.S. annual exports and that an additional 20,000 firms could easily sell their products overseas profitably.

A number of crucial factors have precluded greater participation by U.S. business, and especially small business, in international commerce. In some cases, the lack of export involvement may simply be attributed to indifference or ignorance of existing potential markets abroad. Coupled with these situations is the ignorance of international trade mechanisms and procedures. In other cases, despite price attractiveness, competitive terms, and better quality products, the needs of foreign businesses and governments often exceed the small concern's capacity to manufacture, produce, deliver and service. Although an obvious solution to this problem would be to expand its capacity, because of their small size, these concerns may not have access to the long-term debt and equity funds that are needed to finance business expansion.

Going a step further, those companies that do possess the know-how, do have the capacity to expand, and can export, are often faced with additional disincentives and uncertainties that tend to restrict the flow of goods and services abroad.

Some of these disincentives, often politically imposed, include export controls, restrictions on trade with Communist Countries, Environmental restrictions, Anti-Boycott Statutes and Regulations, Human Rights restrictions, Health and Safety Export restrictions, Cargo Preference laws, and such recently imposed codes of conduct under the Foreign Corrupt Practices Act.

Current Initiatives

It has only been within the last five years that there has been an interest in promoting exports. The first step to formulate a comprehensive program to stimulate U.S. exports was announced by President Carter on September 26, 1978.

The Administration's program focused on three areas of export policy:

1. increased direct assistance to U.S. exporters;

2. reduction of domestic U.S. barriers to exports; and,

3. reduction of foreign barriers to U.S. exports.

The third measure has resulted in a newly negotiated and approved Multilateral Trade Agreement. Many of the provisions of the treaty could provide a potential boon for small exporters, given greater federal support in successfully reaching foreign markets.

This agreement provides for codes of conduct in the areas of product standards, customs valuation, licensing, subsidies and countervailing duties, and government procurement. In addition, certain tariff concessions in the agricultural field should increase business opportunities for American firms.

One of the potentially greatest advantages for small business is the new procurement code. Until now, American firms have been largely shut out of foreign government procurement. The American system of open and competitive bidding on procurement contracts simply does not exist overseas. Under the more relaxed and standardized rules, U.S. firms will now have better access to an estimated $20 billion of foreign procurement. However, federal agencies will have to strengthen their programs to assist small and minority businesses to take advantage of these new markets.

Responsibility for administering foreign trade programs is thoroughly scattered throughout the federal bureaucracy. Export promotion and financial support programs exist mainly in the Department of Commerce, the Export-Import Bank of the U.S. (Eximbank), the Department of Treasury, the Department of Agriculture, the Overseas Private Investment Corporation, the Department of State, and the Small Business Administration. These export promotion programs have long been criticized for lack of attention to the needs of the small, inexperienced firms. While some of these agencies have recently adapted their programs to focus more strongly on small business needs, there are many additional changes that are needed to truly promote small business into foreign commerce.

The Federal Government, mainly through the Department of Commerce export promotion programs, provides services to the potential small exporter in the form of: basic "how-to-do-it" seminars and counseling; foreign market information; specialized marketing research; assistance in obtaining representation and in generating export sales leads; and exhibiting products abroad.

Other primary government agencies that provide assistance include: Eximbank (financial assistance and insurance); the Overseas Private Investment Corporation (counseling and financial support for investors in developing countries); the Small Business Administration (export counseling and financial assistance); and the Treasury Department (Domestic International Sales Corporation, and the IRS).

Although the President's proposals to increase direct assistance to exporters placed major emphasis on increased export credit assistance, he also announced a significant expansion of export promotion programs through the Departments of Commerce, State, and Agriculture. While many critics maintain that large exporters have been primary beneficiaries of Federal Government assistance, the agencies involved deny this.

Several initiatives were announced to help solve the problem of Federal Government imposed disincentives to exports. The President directed the Departments of Commerce, State, Defense and Agriculture to take export consequences fully into account when considering the use of export controls for foreign policy purposes. Secondly, he directed the Justice Department to give guidance to businessmen who were uncertain about the application of the Foreign Corrupt Practices Act or the antitrust laws. Finally, he issued new guidelines on the applicability of the National Environmental Policy Act, which would require abbreviated environmental review only for exports of nuclear reactors, financing of exports which might create serious public health risks, and certain federal actions which might have a significant adverse effect on the environment of foreign countries or on national resources of global importance.

Reaction to federal support programs suggests only limited success. Frequent complaints about inadequate response and a poor delivery system by the Departments of Commerce and State have spurred the growth of State export promotion offices both domestically and abroad to function as a complement to the federal domestic services and commercial officers abroad.

It should be noted that due to Commerce's poor delivery system and penetration of the small business community, yet basically sound programs, many, if not all, of the state operations tap into the federal government's information banks and then, in turn, provide a delivery system necessary for greater access by small and medium sized business. However, neither of these delivery systems provides timely information access, as should be available through the new Worldwide Information and Trade System (WITS) computer system, one part of the President's "National Export Policy."

In March 1978 four federal agencies launched a concerted attempt to educate small business on the programs, services, and opportunities available in international trade. The Department of Commerce, the Small Business Administration, the U. S. Export-Import Bank, and the Overseas Private Investment Corporation joined forces in presenting over 46 field conferences specifically directed towards the small business community. These conferences have been attended by an estimated 11,000 potential exporters. Representatives from these agencies spend the better part of a work day explaining the rudiments of international trade assisted by presentations from private sector service firms and exporters currently successfully exporting. Additional conferences are scheduled for this fall and next spring.

Finally, many private sector organizations provide export promotion opportunities to small business. Operations such as world trade clubs, local chambers of commerce, industry and trade associations, accounting firms, freight forwarders, port authorities, private consultant firms and others provide, to a limited degree, some of the basic information and services found in federal and state government programs.

Criticism that government agencies are duplicating private efforts are perhaps misplaced. To small exporters wishing to enter a new field, the cost of private marketing surveys, research projects, and other services needed for successful completion of every step of the export process, can be prohibitive and are only available on a limited basis.

The aforementioned programs, issues and problems have been the focus of discussion throughout the field conferences held around the country over the last year.

Participants have offered the following types of comments for consideration:

> "The lack of special education appears as the likely cause for the dramatic lag in manufacturing exports. To overcome this deficiency, the federal government should establish several programs for disseminating appropriate export information."
>
> "Provide for a foreign trade specialist in cities with populations over 150,000."
>
> "Increase the number of U. S. trade centers and missions overseas."
>
> "The government should provide tax incentives for small businesses to get involved in international trade."
>
> "There should be a central clearing house to provide information on international trade and assistance to small firms."
>
> "U. S. Embassies should help small business publicize themselves in foreign markets."

> "Reevaluate our legislation on all restrictions which restrain the small business person from entering international trade."
>
> "Evaluate anti-trust laws to allow small business to form trading groups."
>
> "Promote awareness of U. S. programs for small business in international trade."
>
> "Establish regional small business international trade groups."
>
> "Domestic International Sales Corporations (DISC) should be explained and promoted to all small business."

These ideas and others have focused on three major areas of concern:

I. the need for education of small business on opportunities abroad and available programs and services. The business potential in overseas markets is a mystery to small business and the tools neceesary for tapping those resources are unknown;

II. the need for available lines credit at competitive interest rates and capital for corporate expansion to support increased foreign trade; and,

III. the need for effective trade mechanisms for substantial small business participation in foreign markets. A small manufacturer cannot compete with the large trading companies or aggressive foreign country export support programs.

The following paper provides various options, presented for consideration, as means of resolving some of these omissions in federal export policy for small business.

These ideas have been presented by local business owners, reviewed by international trade experts, and refined for further consideration. These initiatives hopefully address changes in federal government program focus, legislated disincentives to trade, and the use of tax policy as an incentive to increase exports.

Enactment of many of these proposals could, conservatively, double small business participation in international trade within the first two years. In the MASSPORT program alone, 25 companies generated $2.2M in trade in their first attempt at international trade. Comparable increased participation by small business on a national scale could easily result in an additional $180M in export sales.

The MASSPORT program leads a potential small exporter carefully through an export program which includes: market surveys, pricing of products for export markets; interest-free loans to travel to his market; services through the local MASSPORT representative; and introduction to potential clients and guidance through the actual transaction.

Increasing U. S. small business exports is a major challenge -- for business, for labor, and for government. Better export performance by the United States would spur growth in the economy. It would create jobs. It would strengthen the dollar and fight inflation.

There are no short-term, easy solutions. These proposed actions may be the first step in a long-term effort to strengthen this Nation's export position and small business' contribution to world trade.

OPTIONS

EDUCATION AND EXPORT PROMOTION

The options in this section attempt to redress the many problems of information access and dissemination by the federal government export promotion apparatus.

All too often the federal government responds to the needs of the small business community, but fails to adequately inform its constitutents of available counseling programs, services, or other forms of support.

Part of the problem has been generated by the fragmented federal structure that is responsible for administering the foreign trade functions. Currently responsibilities lie in: Office of the Special Trade Representative, the Departments of State, Commerce, Treasury, the Small Business Administration, the Export-Import Bank, the Overseas Private Investment Corporation, the International Trade Commission, the Commodity Credit Corporation, the U.S. Department of Agriculture, the Office of Management and Budget, and Export Control Committees. The political realities of reorganization will probably hinder the creation of a separate department which would have exclusive jurisdiction over the area of small business and export trade.

The Department of Commerce has traditionally been the lead agency in the field of international trade. It has offices located in all major regions in the country and logically should be the agency which would coordinate such recommended programs as the local One Stop Services as well as administer a grant program to support state and regional export stimulation programs.

The Export Import Bank is structured within the Department of Treasury and is located in Washington, D.C. It has no regional offices. Its major functions are to provide for financing and loan guarantees for American exports. Related to the bank are two additional: the Overseas Private Investment Corporation (OPIC) which organizationally is structured under the Federal AID agency, which insures against foreign expropriation, and the Foreign Credit Insurance Association, (FCIA), a private organization located in New York City which insures credit obligations of exporters.

Above and beyond the federal support programs, the problem of small business input to the trade policy formulation process is considered as important as any other concern. It is hoped that the options provided respond to these concerns both in terms of access to whatever structure is devised and in terms of direct participation by small business concerns in the many appointive positions available in the federal government trade apparatus.

Option 1

The President and Congress should consolidate both U.S. trade policy coordination and trade negotiations in the Office of the Special Trade Representative; the day-to-day operation of trade functions in the Department of Commerce; and broaden the mandate of the interagency Trade Policy Committee.

Discussion

With so many agencies currently dealing with exports, it would be best to coordinate through the Special Trade Representative, which has responsibility for negotiating international trade agreements and is structured within the White House. This organizational structure will centralize authority for U.S. trade activities, both policy-making and implementation, will promote improved coordination between trade and other U.S. policy objectives and upgrade the priority of government trade activities.

Additionally, it will establish a strong authoritative voice in the Executive Office of the President to provide coherence and leadership to U.S. trade policy and negotiations through the Interagency Trade Policy Committee composed of representatives from all participating agencies, and make one Cabinet Department and one Cabinet Secretary responsible for the operational side of government trade activities.

The Congress is currently considering this proposal with possible suggestions for amendment.

Option 2

The Federal government should retain the existing situation within the federal bureaucracy including the same distribution of authority at the Regional levels.

Discussion

The existing system, though fragmented, provides specialized attention on the many parts that constitute the trade process. However, potential small exporters are more often confused, discouraged, and frustrated with having to contact a myriad of federal agencies to learn how to export and what help they can expect.

This system does not lend itself to accurate accountability nor does it provide any focal point for relevant policy development.

Option 3

The President should establish a Cabinet level Department of International Trade composed of all of the trade policy functions of the executive branch agencies and departments.

Discussion

This type of federal structure would enhance development of a coherent federal trade policy, focus responsibility and accountability with one central authority, avoid duplication and waste.

A Department of International Trade would reflect the priority placed on exports and provide the impetus needed for comprehensive federal support. It would also enhance the development of a one-stop service structure, for potential small exporters, both in Washington and in field operations.

Opponents claim that this provision would increase government's role in International Trade and simply reorganize existing allegedly ineffective government services and programs.

Executive reorganizational initiative along with Congressional review would be required for implementation.

Option 4

The President should establish, within the Department of Commerce, an Agency of International Trade and Investment responsible for all of the trade policy functions currently administered by the various agencies and departments.

Discussion

Proponents feel that the existing programs and services provided through the Department of Commerce have a solid base and need improvement.

The Department of Commerce has the field personnel, regional apparatus, foreign country knowledge, and export promotion experience necessary to combine resources from other agencies to administer all programs and services provided through the federal government.

Opponents feel that the existing apparatus is ineffectual both in terms of structure and effectiveness; it would simply exacerbate and ruin any hope of improved support, and would still not provide sufficient high level input for small business in the policy making apparatus.

Executive initiative would be required along with Congressional negative prohibition.

Option 5

The Federal government should establish a field one-stop service shop, in one physical location to include export services of all federal agencies.[1]

Discussion

A potential small exporter should be able to go to one office and receive the whole spectrum of information that might be needed for exporting -- marketing surveys, country information, tax information, financing, investment insurance, and credit insurance, as well as advise on export pricing, shipping, etc.

---

[1] For further discussion see Economic Policy and Government Programs, Option 14.

A one-stop service team should include representatives from: Commerce, SBA, Eximbank, IRS, OPIC, and FCIA. Once the overall definition of the proposed transaction is reached, then it might be best to direct the small exporter to existing private or public firms or agencies that have ongoing export promotion programs. A good example of a public program is MASSPORT, sponsored by Boston Port Authority, which has been successful in bringing local small businesses into foreign trade transactions. In most cities, there are private export companies, managers and brokers to assist small businesses. Other options will be presented on how to strengthen the private AMERICAN EXPORT TRADING COMPANIES to better serve small businesses.

This provision would require Executive initiative along with positive support from the Congress.

Option 6

The President should provide for significant small business representation on the President's Export Council.

Discussion

Currently very few members of the President's Export Council provide the small entrepeneur's viewpoint on all trade issues raised by the Federal Government. The Council is dominated by large "Fortune 500" corporations. While they have a great deal to offer, a better small business balance is necessary. Trade policy advice sent to the President from this group should incorporate these ideas.

The President has full control over the appointments to this advisory body.

Option 7

The Department of Commerce should develop and market the Worldwide Information and Trade System (WITS).

Discussion

As designed, this computerized international marketing information system will be linked by worldwide communications satellite to all key Commerce offices in the U.S. and Foreign Service posts, as the most comprehensive data resource of its kind.

Small business could be provided with hard leads to potential business contacts; actual offers to export specific products; up-to-date statistics and information on market conditions and potentials abroad. All this information would be available in a timely fashion through private sector tie-in on a time-share basis. Some concern does exist over the reliability of the market information input.

In some cases a significant problem is that the present system is dated and not sufficiently sophistocated for specialized exports.

The President has made a commitment to such a system and has received Congressional funding support for the pilot project.

Option 8

Congress should provide for support and expand use of all officially recognized Trade Fairs, Exhibitions, and Trade Centers abroad with subsidized small business participation.

Discussion

The need and oportunity to exhibit products and services abroad can be most effectively met through participation in programs linking the small exporter with his potential clients.

These programs have been hailed by small business around the country as potentially some of the most effective and useful programs in government to help small business exporters.

The cost, after the initial trip, of participating in Department of Commerce trade fairs can be prohibitive to small exporters. Incentives could include reasonable rent for exhibit space and low interest loans to pay for transportation costs and accomodations.

Option 9

Congress should provide for the establishment of International Trade Development Centers.[2]

Discussion

The development of educational tools to explain some of the more complex problems involved in international trade should be established at the local level through educational institutions. Private sector role models should be provided to assure the most optimal rapport between new to export firms and old hands.

Legislative acceptance of the ITDC concept would be required for implementation.

---

[2] For further discussion, see Economic Policy and Government Programs, Option 18.

FINANCIAL SUPPORT

The need for available lines of credit at competitive interest rates and capital for corporate expansion to support increased foreign trade are probably the two most important components of a successful trade transaction.

Linked to these two necessities is the availability of insurance, both pre-shipment and post-shipment, for actions that may be beyond the control of the exporter.

This section will provide an assortment of options that aim at assisting the potential exporter in retaining profits from foreign transactions, if such profits are used for increased expansion into foreign markets, and as a direct incentive to do so if not involved in international commerce at this time.

Such incentives can most appropriately be provided in the form of government guarantees or through programs that offer credit at competitive interest rates.

Additionally, certain appropriate changes in the tax code will provide incentives to hire more U.S. workers and to compensate U.S. firms for expanding their operations into international markets, expecially where great risks are involved.

The complications of a myriad of rules and regulations on foreign tax credits, taxation of U.S. citizens abroad, DISC corporations, and the like, can easily cause a bias among small business not to engage in international trade.

A. Taxation

Unfortunately, the Internal Revenue Code and IRS can be the principal impediment in an expoort transaction. While a large multinational corporation can afford a tax department, and can retain high-priced Washington law firms, the small exporter is left at the starting gate in his efforts to deal with tax problems of international transaction.

The complications of a myriad of rules and regulations on foreign tax credits, taxation of U.S. citizens abroad, DISC corporations, and the like, can easily cause a bias among small businesmen not to engage in international trade. Very rarely does the IRS go out of its way to come down with a ruling in favor of an exporter. For example, the IRS is not enamored with DISC corporations, and as a result, a DISC is a very expensive organization to establish and maintain because of complex rules, regulations and interpretations.

Option 10

The Internal Revenue Service should establish an IRS Small Business Export Task Force to help develop a relatively simple program of guildlines for potential small exporters.

Discussion

The IRS should have a representative on the one-stop service unit and should attempt to give the small exporter prompt rulings on tax problems facing him in his overseas transactions.

Development of this advisory task force would help sensitize the IRS to the specific problems and needs of small business. Additionally, with the development of a program designed to assist the small exporter, fewer complications would result.

Option 11

Liberalize existing tax treatment imposed on U.S. citizens working abroad.

Discussion

Compared to our international competition the U.S. has by far the strictest tax treatment of its nationals abroad. The present law makes it impossible for the U.S. to be competitive in the international labor market. As a result, Americans are being forced to return to this country, and their place is being taken by nationals of competitive countries, who do not have the severe tax liabilities of the American.

In labor-intensive industries, such as construction, we are finding our world share rapidly diminishing. The majority U.S. constructors, in order to remain competitive, are hiring foreign technicians. This action has the tendency to cause the project to use fewer U.S. components, as a foreign engineer would tend to order machinery from his own country.

For the small businessman with a two or three person office overseas, the added tax bite can put him out of the competition. Servicing the equipment he has exported becomes difficult. Increasing sales through his own sales force becomes difficult.

The U.S. should adopt a tax on its citizens which is related to the system of taxation used by our major competitors. Generally, this would be to tax income only when brought back to the U.S.

As an alternative, the law should be changed to its pre-1976 version, a standard $20,000 exclusion off the top, and a full foreign tax credit allowance.

Option 12

Allow for greater flexibility and broad interpretation of sections 901-903 - Foreign Income Tax Credits against U.S. tax liability.

Discussion

IRS rulings on what foreign taxes can and cannot be credited against U.S. income have been contradictory and confusing. It is, frankly, impossible for the small businessman to keep track of the rulings, and if the IRS were to disallow a credit, the small businessman could well be forced to abandon a foreign transaction. The criteria for a foreign tax to be creditable is whether it is narrowly analogous to the U.S. income tax. This causes many taxes on the gross value of a transaction, and withholding taxes, to be deemed non-creditable.

These code sections should be clarified and clear rules and regulations should be adopted. The criteria should be based on what our major competitors do in their treatment of foreign tax credits. Because each country has its own history and economics, we should not use the U.S. income as the sole criteria for judgment.

IRS interpretation policy could be encouraged by the Executive Office of the President.

Option 13

Structure export transactions within our tax structure to allow for an alternative to a comlicated DISC corporation. The alternative could be a "Phantom VAT" where a Value Added Tax (VAT) is computed according to European Economic Community practices. On small business exports the tax is rebated to the exporter.

Discussion

In the Common Market, the VAT is the form of sales or consumption tax. When a product is exported, the accumulated VAT is rebated to the exporter. This rebate could range from 5 percent, to over 20 percent and, in fact, becomes an export subsidy. Because the government can set various levels for the VAT on specific classes of products, the VAT export subsidy can become very selective and thus very competitive.

By structuring export transactions so that the VAT is computed according to EEC practices, the government would then rebate the VAT amount to the exporter when the goods are shipped. This system could be an alternative to a DISC, and would certainly be more convenient and less expensive than a DISC for a small businessman.

Adapting our tax structure would require Congressional revision of the USC.

Option 14

Congress should provide small exporters with a 10% investment tax credit for research and development expenditures.

Discussion

At a time when our own R&D expenditures are falling, and those of our competitors are increasing, there needs to be more incentives for R&D. Much of the innovation made possible by R&D has been from small business, and they need tax incentives to survive in the highly competitive international marketplace.

Legislation is currently pending (S. 700) which addresses this concept.

Option 15

Congress should simplify and delineate specific rules for calculating tax deductions for foreign bad-debt losses.

Discussion

This concept would provide for favorable tax treatment for certain market development expenses -- a clarification of Section 174 of the USC. It would provide for a tax deduction on currently fluctuation credit, and on export losses, which have not been repaid by the end of the taxable year. This provision would be of significant benefit to the small exporter with tighter cash flow problems.

Currently, legislation (S. 1003) before the Senate Finance Committee is under review.

Option 16

Congress should provide a tax credit for hiring qualified export managers.

Discussion

In the long run, one of the most important criteria for successful exporting is qualified personnel. Qualified personnel are a key ingredient in virtually every facet of export - from marketing to distribution to financing - in exporting companies as well as in those organizations that service exporters. However, one of the greatest expenses in an exporting organization is the expense of people.

It generally takes anywhere from several months to two years or more for an exporter to recover the added expense of an additional person through either additional revenues or decreased operating costs. Small businesses desirous of exporting are concerned about cash flow and incremental expenses. Thus, there is a reluctance to add new employees.

It is my proposal that exporters and exporter service organizations be given a tax credit for hiring additional staff. This technique has precedence:

1. Tax credits are given for hiring minorities
2. Manufacturers are given tax credits for adding new equipment (and people are to an exporter what machines are to a manufacturer).

Option 17

Congress should concentrate anti-boycott law administration in one agency, preferably Commerce.

Discussion

Concentration of anti-boycott law administration could be effected by retaining the Export Administration Act and repealing the Ribicoff Amendment. The Ribicoff amendment in the Internal Revenue Code, which is administered by Treasury, disallows DISC and deferral tax treatment to U.S. companies which agree to participate in a boycott. Additionally, there is also the Export Administration Act with its comprehensive anti-boycott title. Having two agencies, with two laws, with two sets of rules and regulations, causes an extremely heavy burden for the small businessman doing business with a country which participates in a boycott.

A change of this sort would require Congressional review and positive action.

Option 18

Congress should broaden the tax deferral options of the Domestic International Sales Corporation.

Discussion

A DISC - Domestic International Sales Corporation - is a category of corporation added to the Tax Code by the Revenue Act of 1971. A DISC is entitled to defer Federal income taxes on 50% of its export income.

A DISC can operate as a principal, buying and selling for its own account, or as a commission agent. It can maintain sales, and service facilities abroad to enhance its foreign promotional and marketing efforts.

Broadening of the tax deferral options should include the following provisions for DISCs:

- allow for deduction of twice the monies expended for participation in any bona fide overseas trade fair by a DISC;
- allow for the deduction of twice the amount of premiums paid to Eximbank and FCIA, as legal deductions prior to payment of DISC taxes;
- increase the $100,000 exemption clause to $500,000;
- provide for a graduated tax on "deemed distribution" from $500,000 to $50 million, and a standard rate of 50% levied on over $50Million;

- exempt new DISCs from any "deemed distribution" requirement for at least the first three years of operation; and,

- provide for the elimination of existing incremental provision of DISC regulations.

These proposals would entice smaller exporters to form DISCs and increase their participation in international trade and trade fairs (which have proven to be highly effective sales tools). Additionally, many of these provisions would enable DISCs to increase their capital base for expansion of export functions and provide incentives to launch or expand costly export programs.

Legislative amendment to existing statute would be needed to implement these changes.

Option 19

Congress should provide for an "Exporter's Allowance" which would apply in the trade of all goods abroad.

Discussion

Goods exported or that are produced or manufactured for export or in the course of which orders for goods are actively solicited in any export country would be granted an allowance for 75% of the marketing expenditures incurred by the exporter during the year of assessment.

This provision creates an incentive to exporters or to potential exporters to enter the export field and obtain an income tax benefit without creating a DISC corporation. The basis of its provision would allow certain marketing expenditures which, in the normal course of business, would be a deduction accepted by the IRS to become a deduction based on the increase in export sales from one fiscal year to another.

The exporter's allowance would not require any additional paperwork, as is required for a DISC, and could be introduced as a legal deduction in the current tax system. Legislative approval would be required for implementation.

B. Federal Programs

Option 20

The Small Business Administration should be empowered to provide financial assistance to small exporters and Export Trading Companies through their existing lending and loan guarantee powers to expand their present facilities domestically and abroad.

Discussion

The SBA currently has financing authority for small business guarantee programs and would not be required to increase existing apparatus to deal with this expanded service.

The President has directed the Small Business Administration to provide $100 M in guaranteed loans to be funneled for greater small business participation in international trade. The authority currently exists and could be used for support of trading companies or other mechanisms established to increase small business access to foreign markets.

Congressional authority would be necessary for increased guarantee authority if guaranteeing of trading company requirements becomes a reality.

Option 21

SBA should provide a structure for selectively discounting loans made on export transactions.

Discussion

The risks are certainly greater in export transactions than in 30-year mortgages, but these can be dealt with through prudent financial management.

One of the great advantages of most international trading companies is that they have a heavy-volume turnover in their transactions. A U.S. exporting company is restricted in its debt-equity ratio, which is tightly controlled by its commercial lenders. A 1/2-1 ratio is normal. On the other hand, a foreign trading company builds its ratio up to 20 or 30-1. This ratio on financing means that a foreign company can turn over 20 to 30 more transactions than a

U.S. businessman or trading company. Turnover also affects price, and the faster the turnover of export paper, the lower the price of the goods or service to be sold.

Congressional authority would be necessary for funding through the Federal Finance Bank, as well as Congressional authorization through the Budget Act.

Option 22

Congress should provide for a special SBIC program tailored to the needs of international business.

Discussion

The SBIC could stand alone or could be a part of an export trading company. With the confusion of definitions of small business, an international SBIC should probably have expanded levels on the capitalization of companies in which an SBIC might invest.

The SBIC's parent company or an affiliate corporation would be engaged in developing, promoting, and marketing export opportunities for U.S. businesses. If market potential is identified, then the SBIC would be in a position to provide the necessary financing to the small manufacturer. Further, the marketing arm, or a management services subsidiary of the SBIC, could assist the small business in negotiating export transactions.

Additionally, the SBIC or an affiliated company could also assist the small business concern in making use of the programs of the Export-Import Bank and the Foreign Credit Insurance Association to provide financing to its export customers. It could also assist in arranging complete financing packages for small concerns which have needs exceeding the capacity of the SBIC. Finally, other components of the SBIC and its related organizations could assist the small concern in obtaining necessary expot licenses, transportation arrangements, and other administrative activities not normally associated with the concern's domestic U.S. business.

The authority to create such an arrangement would require Congressional amendment and expansion of SBIC authority.

Option 23

Congress should strengthen MESBIC (301-D Corporation) legislation to allow for greater use of MESBIC capital for leverage in international transactions.[3]

Discussion

As a nation of many minorities, we should have the ability to penetrate many yet untapped lesser developed country markets. An international MESBIC format would give that exporter penetration into those markets. This provision would require legislative expansion of MESBIC authority.

It will provide for tax allowances for MESBIC financed operations that expand into international markets. Specific provisions to include allowing for conversion of retained earnings into capital stock as free bonus stock isssue.

Option 24

Develop a grant program through the federal government or state governments to provide financial backing for the establishment of programs similar to the highly successful MASSPORT Small Business Export Program.

Discussion

MASSPORT provides potential small exporters with professional guidance through an export process. Market survey, pricing of products for the market, an interest-free loan to bring the small exporter to the market, and services through the local MASSPORT representative to introduce the exporter to the potential client are all provided.

This type of program would require minimal financial support to establish (immediately) in certain regions of the country. Administering a national program through existing DOC apparatus along with a small Washington staff of troubleshooters (10-15) would suffice.

---

[3] For further discussion see Minority Business Development, Option 12.

Small business success in this program could be documented within the first six months of operation as has been evidenced in the MASSPORT results.

Option 25

Eximbank should establish a special small business funding program through commercial banks who would advance all funds and obtain a guarantee from Eximbank/Foreign Credit Insurance Association (FCIA) under a blanket policy for 80% of the advance; commerical bank risk to be set at 5%; and shipper risk at 15%. Individual participation should be limited to five years of operation in foreign markets.

Discussion

This type of program would attempt to increase commercial bank involvement in international finance by allowing them to make direct Eximmbank guaranteed loans. The loan process itself would be under the direction of the private sector and would not require federal government involvement. In this way, export financing could be brought to the local level instead of being isolated in Washington, D.C. or in a few money market centers.

This proposal would greatly aid the small exporter who is invariably penalized for the fact that his transactions are smaller quantities. It would significantly help in increasing the percentage of U.S. producing firms able to engage in exports.

Eximbank can establish this program through Administrative action.

Option 26

Eximbank should consider reducing, and in some instances eliminating, the exporters retention (amount of risk incurred) and commercial bank participation under the Bank Guaranty Program.

Discussion

This change would help provide a sorely needed incentive to increase small exporter participation in international trade by providing more liquidity in export transactions, thus stimulating a greater volume of sales. This change would also provide an incentive to commercial banks by lowering their percentage risk involvement.

While this would largely help inexperienced corporations, it does not provide the ongoing encouragement available to larger corporations under the Direct Lending Program.

This change within an existing program could be accomplished quickly through executive and administrative decision.

Option 27

Eximbank, as OPIC, should consider issuing bid and performance bonds on behalf of small business or guarantee commercial bank issuance of bid and performance bonds on behalf of small exporters against unforseeable political changes in the importing country.

Discussion

This provision would eliminate one of the major hurdles experienced by smaller exporters -- lack of capital necessary to open the bid and performance bonds required in obtaining and fulfilling export contracts. Many times an exporter cannot perform on a contract because of sudden changes in government and laws of an importing country. It would also help later when competing for larger export contracts. SBA apparatus in the Surety Bond Program could be adapted to do this.

Option 28

Eximbank or the SBA should consider providing pre-export financing to small businesses who have "bona-fide" export contracts; or should consider guaranteeing commercial bank credit extensions for this purpose.

Discussion

This program would substantially help address the problem of capital inadequacy common to smaller exporters who might lose contracts by small business because of a lack of pre-export financing, despite the fact that they have bona-fide contracts in hand. SBA can do this through its regular loan process.

The decision to expand into this type of program rests with the Board of Directors of Eximbank.

Option 29

Eximbank should consider discount loans to support international sales, at rates comparable to those offered under the Direct Lending Program.

Discussion

Where there is evidence of more favorable rates being offered by foreign government support competition, then Eximbank should match those rates in favor of small U.S. exporters.

Under this proposal small and medium sized firms that typicaly sell less costly items will be afforded as favorable an interest rate as those dealing in major transactions taking advantage of the Direct Lending Program. Favorable interest rates in discount loan program would significantly assist small U.S. firms compete against other countries for foreign contracts.

These changes can be accomplished by Eximbank without the need for legislative amendment.

Option 30

Eximbank, should be established as a commercial bank under the Federal budgetary process with a loan loss-reserve operating structure.

Discussion

There should be a loan-loss reserve, based on - for example - the loan experience of the bank for the last twenty years. The additional reserve to cover additional lending authorization would come from a federal budget authorization.

Under present law, the authorizations and guarantees of the Eximbank are considered federal expenditures. The problem with government loan and guaranty programs is that they are all different. The National Student Loan Program, from a banking standpoint, is a disaster.

A dollar lent by Eximbank makes money. It collects interest and is paid back. It is a different dollar from an actual expenditure for a new DOD missile system, or revenue-sharing for welfare. Those are expenditures; the money is spent and that's it.

When an Eximbank dollar is lent, the bank takes back an accounts receivable. It is trading one asset, a dollar, for another asset, an accounts receivable. The money comes back with a profit.

In the budget process, where there is no separation between these different transactions, a loan is treated the same as an expenditure. A $500 million increased authorization for the banks lending authority is treated the same as $500 million for an expenditure that never comes back. Because of this, there is reluctance from both the Administration and the Congress to increase the loan authorization of the Bank. Lending becomes a domestic, political issue rather than a trade issue.

As long as every loan or guaranty of the bank is an item in the federal budget, the bank will not be able to compete effectively with its international competitors, and more important, will not be able to service the needs of small business.

Option 31

Eximbank loan programs should be coordinated with low interest loan programs in AID, Agriculture, and Department of Defense -- "Mixed Credits."

Discussion

There is presently a "Gentlemen's Agreement" among export financing agencies on export transaction terms. This country has been rather naive in these types of agreements, because we isolate the Eximbank from all of our other programs that deal with international trade. Other agencies, especially AID, deal with low-interest loans. Small Business should have the ability to use "blended credits" by both subsidized and non-subsidized rates to reach a competitive rate on transactions. These "blended rates" are used extensively by our foreign competitors to effectively compete against Eximbank rates.

Administrative initiative to blend loan programs from different agencies could be accomplished without Congressional revision as long as the intent of Congress and the financial integrity of Eximbank are not violated.

Option 32

The Foreign Credit Insurance-Association (FCIA) pre-shipment coverages should be expanded to include indemnification for loss arising out of the cancellation of orders by any public-sector foreign buyer and by any private sector foreign buyer approved by FCIA for this purpose.

Discussion

The cancellation of orders can virtually bankrupt a small exporter. In most of these cases, the circumstances that cause cancellation are totally beyond the control of the exporter. Providing insurance for this type of risk would help in assessing the benefits of exporting rather than simply attempting to expand domestically.

Option 33

The Congress should remove political restrictions from the Eximbank Act. Issues such as trade with communist countries, boycotts, human rights, emigration, and expropriation, should be matters of current national policy under the direct control of the President and should not be incorporated into a statutory straight jacket.

Discussion

These types of restrictions in the law cause uncertainties with the small exporter and cause him not to enter into export transactions. In some cases, the problem that might have motivated the restriction no longer exists and the legislative process to change the law is very slow.

Removal of these restrictions would require joint efforts by the Administration and the Congress.

Option 34

FCIA's short term pre-shipment program should be amended to assure policyholders of the availability of post-shipment coverage or indemnification for loss if shipments should be barred.

Discussion

The present program covers losses caused by political risks and insolvencies occurring during the pre-shipment period, but post-shipment coverage is not assured in advance. Coverage should be provided at both ends of the transaction, until payment is made in full. In some cases political expediency may dictate changes in trade policy that may preclude completion of the transaction.

Option 35

Utilizing FCIA as the insurance vehicle, Eximbank should begin to write coverage for loss arising out of the arbitrary calling of on-demand bank guarantees (or the calling of these guarantees following specified political events).

Discussion

In many foreign transactions, the potential foreign buyer may demand that the U.S. exporter submit to on-demand bank guarantees. In some documented cases, arbitrary cessation of contracts by foreign buyers leaves the small exporter in a difficult situation. The exporter would not be able to secure this contract unless he did submit to on-demand bank guarantees.

This change could be accomplished within the statutory authority of the Eximbank.

Option 36

FCIA should allow the individual exporter to enter into some form of insurance risk-sharing arrangement.

Discussion

Via an exchange of indemnity agreements or through formation of a separate corporate entity, this risk-sharing arrangement would be limited to a specific maximum, i.e., the amount of the deductible authorized by FCIA to the group as a whole.

FCIA understandably prefers to authorize large deductibles in exchange for the granting of high Discretionary Credit Limits. This insured group would be treated by FCIA as if it were a single policyholder paying a substantial premium. The group would be authorized by FCIA to try to secure some form of spread-loss insurance to cover the risk-sharing area within the deductible. This proposal would enable small companies to consolidate and make use of FCIA programs more effectively.

Adoption of this initiative would require new administrative procedures within FCIA.

TRADE MECHANISM

Most small business do not have their own International Division and do not possess the knowledge and sophistication to operate in the complex field of trade. For those that do, and have ventured forth, the benefits have been substantial. However, to establish an international division, or even to hire an export manager, is generally beyond the resources of the potential small exporter and, as a result, their basic orientation is fixed on the more familiar domestic market.

There are export companies, brokers, and managers throughout the United States. For the most part they are small with limited capital resources. They tend to specialize in specific product lines and in limited foreign markets. There need to be more incentives to cause these companies to grow to a scale where they can effectively compete with the European and Japanese trading companies, and can offer the full range of services for a greater international market.

The following section provides several options by which small business can improve its competitive position in world markets. Some companies will find it profitable and possible to expand internally, but others will need other means to sell their products abroad.

Option 37

Congress should provide for the development of "American Export Trading Companies."

Discussion

The American Export Trading Companies will deal with all varieties of foreign marketing needs in the emerging, less developed and developed countries. The management of the commercial and financial risk by this entity will provide the U.S. manufacturer increased profits in the expanding international marketplace, reduce the manufacturers dilution of top talent and the economic risk of venturing into new areas.

The American Export Trading Companies should be incorporated in the U.S. with exclusive overseas sales territories for U.S. manufacturers; provide American manufacturers with a practical, effective interface with various foreign business practices; provide substantial economies of scale resulting from consolidated warehousing, transportation, and commercial services; be familiar with all techniques of receiving payment for goods exported and have the ability to pool each country's differing business risks.

Accelerated expansion of exports to achieve a balance between the volume of U.S. import and export trade will require government assistance. This can be arranged in the form of guarantees, credit cost subsidies, refinancing or discount facilitation through the commercial banking system, the Export-Import Bank and the Small Business Administration.

A concerted effort will be needed to join government and business in promoting and supporting such entities. Legislative authority will be required for such a venture.

Option 38

Congress should amend the Edge Act to strengthen the ability of commercial banks to be export trading companies, or part of export trading companies.

Discussion

An Edge Act Corporation is generally a subsidiary of a domestic bank which specialized in international transactions. There is no requirement that an Edge Act Corporation be a subsidiary of a commercial bank. One might actually be started as the financial arm of an export trading company, with approval of the Federal Reserve Board.

Bringing an Export Trading Company into an Edge Act Corporation with a tie to a large bank with overseas offices might be the base of an organization that would have the economies of scale needed to be a true international trading company.

Option 39

Congress should expand and clarify the Webb-Pomerene Act.

Discussion

This Act of Congress was passed for the purpose of exempting U.S. export trade associations from the Sherman Anti-Trust Act, if they did not lessen competition in the U.S. This opportunity to form associations has not been used as extensively as it should have due to the vague language in the Act and a strong bias in the Justice Department against the Act.

The Webb-Pomerene Act should be expanded to include service related industries, such as: construction, engineering, architecture, finance, and insurance so that the Act reflects the whole range of foreign trade as it is constituted today.

These changes would require Congressional interpretation and amendment of existing statute.

Option 40

The Federal government should support and closely coordinate federal efforts with export efforts of state and regional organizations.

Discussion

Current government programs do not sufficiently encourage small businesses to participate in international trade. The complexities and risks are such that the potential small exporter will opt for the domestic market -- there is no one to lead him from the Commerce Department brochures, to completion of an export transaction.

The MASSPORT program is a very impressive concept. A potential small-business exporter is led carefully through an export program: market surveys, pricing of products for the market; he is then provided with an interest-free loan to bring him to the market, services through the local MASSPORT representative to introduce the businessman to the potential client, and then guided through the actual transaction.

These locally funded programs generally have a better "grass roots" approach to export promotion. There should be Federal funds to aid these existing programs to expand their services and to develop new initiatives.

This concept could very easily become functional through joint resolution of the federal government and private sector operations.

Option 41

Congress should revive the Department of Commerce Joint Export Awards.

Discussion

This program provided grants for the establishment of State international trade offices abroad. The federal government would fund 50% on a repayment basis over a long base period.

This type of local grass roots structure is essential for an effective sales penetration that could eventually expand into a MASSPORT type operation with federal support.

Full implementation of this program by Congress would require an increase of DOC budget or redirection of existing export program funds.

Option 42

The Department of Commerce should, when appropriate, encourage potential small exporters to enter into a relationship with an appropriate Export Management Company that will act as the "International Division" for the firm in question.

Discussion

The Federal Government, where appropriate, should direct more small businesses towards export management companies as effective facilitators of foreign trade.

These companies will assume the risk and liability for the international transactions, thus reducing one of the obstacles to expansion into international markets. Most of these operations specialize in product lines and are familiar with foreign market demand, customs, regulations, and trade procedures.

This method of exporting can be a more realistic means for initial expansion into foreign markets until the potential small exporter learns the correct procedures for successful independent exporting.

Option 43

The Department of Justice and the Securities and Exchange Commission should provide comprehensive clarifications of the Foreign Corrupt Practices Act.

Discussion

The Foreign Corrupt Practices Act as adopted in 1977 has not been clarified by the Department of Justice or the SEC. Given different practices and attitudes in every country in the world, Justice is reluctant to issue guidelines for fear that exporters will exploit whatever loopholes might exist. Because of the strong criminal penalties in the Act, a prudent business owner would tend to avoid any transactions which might possibly fall within the perview of this Act.

In many cases, small business when unsure of a U.S. law and what guidelines to follow will opt for the more traditional and familiar domestic market.

The President has issued an Executive Order calling for these interpretations and guidelines, but none have been forthcoming.

Option 44

The Federal Maritime Commission, the Department of Transportation, Department of Justice and the Interstate Commerce Commission should eliminate confusion and inequities felt by foreign handlers and domestic foreign forwarders.

Discussion

For the last decade administrative confusion between the Federal Maritime Commission, the Department of Transportation, the U.S. Department of Justice, and the Interstate Commerce Commission has resulted in a bureaucratic nightmare for small exporters.

Several options should be clarified and provided for. These include:

- allowing non-vessel common carriers and domestic forwarders to publish inter-modal rates;
- the formation of shippers' councils and open conference membership, and the right of independent action by an individual steamship line within a steamship conference; and,
- support of the "neutral container system" under which independent leasing companies supply containers to shippers, who in turn tender them to liner operators.

These provisions would help small independent leasing companies to compete openly and freely, would help small American flag carriers to hold their own within the conference system, and would improve the movement of containers on through shipments in international trade.

Mr. **Nowak**. Tom, thank you very much. I think you brought a different perspective and a very practical one to what the real problems are out there. Sitting here trying to write legislation, you always have the problem of trying to fit specific instances in a general piece of legislation, which comes out then as a series of regulations that are almost impossible to get through for the specific that is out there.

The latter point you made about guidance and information is probably the strongest one that we could focus on in the timeframe before we explore the modifications of DISC. We are really talking about two different big problems. As you indicated in your testimony, we should try to put together something that makes economic sense, and at the same time, fits into the broader problem of international and trade restrictions and foreign policy and defense considerations. Delays in commerce bring about the uncertainty of trading, and may eliminate participants in DISC, not because it can't provide a product at a competitive price, but because they can't get through the system, so to speak, to get licensing in time, among other things.

The complexity problem, in general, is something which has to be attacked if we are going to retain even a modified version of the DISC. It is certainly apparent from our testimony this morning. It is like that for many other tax matters. As you know, the Tax Code is filled with exceptions, exemptions, and requirements. When it finally comes out in the regulations, people just can't spend the time, especially if you are a small- or medium-sized firm to actually implement a total sale.

When we present this whole package to the Ways and Means committee, we are going to highlight the differences. You are right that 90 percent of the volume business is done by a very few large corporate people in America. There are some indirect benefits to the small business communities, their suppliers, so there is, I am sure, a ripple effect to the small business community. But to take advantage of the DISC directly, and to become an international trader, is going to require something along the lines of what you are suggesting, almost a walk-through situation. There will have to be a tremendous informational effort to get to those potential exporters who are out there and are just overwhelmed by all of these problems, such as the change in currency, whose ship should carry their product, and if their market is really there after they ship it.

I think that Commerce, if we are going to make a real effort here, has to act immediately to try to supply that information and do a better job with that kind of an initiative even before we change this DISC. When we do change it, I would hope that we will make it available to trading companies such as yours and others so that you will be able to make clearer sense of all of those so-called corridors that you talked about, and be able to get people through them.

Mr. **Rees**. Mr. Chairman, I have three specific DISC recommendations I made 2 years ago, but nothing has been done to the Code since then. Could I read these into the record? I will then give you a copy of the recommendations. There are three specific amendments.

The first would broaden the definition for engineering architectural services for construction projects. The definition in DISC is rather narrow, and you find a lot of the small and medium people that do get into these fields are providing services. This is where our real strength has been, namely providing services. The amendment would increase that and bring in procurement, construction planning, mobilization services, clerical, data processing, and reproduction services. There has been a tendency to narrowly define that, and not allow it as part of the export receipts.

The second one deals with the deemed distribution. I brought that up before. If you miss your 95 percent 1 year, the whole DISC distributed. What I would like to do here is to state that the deemed distribution would be for that specific year and not the complete DISC. You might have a DISC with 15 years of receipts.

The third one, with a small DISC, you are permitted to defer all of the tax on your export income up to $100,000. Really you are talking about pretty active small- or medium-sized exporters or manufacturers. We use as our definition of small and medium businesses any company with sales of less than $100 million; that is about the Fortune 1,000 cutoff. What we would do is to increase that up to $1 million, and then we phase out that extra benefit between $1 million and $2 million. A lot of times you find a person getting to the $100,000 threshold and they don't know what to do, do you not export or leave it outside of the DISC or what.

These are three specific recommendations in draft form that might be of help to the committee.

One other thing that I thought about is, with the passage of the Trading Company Act, if there could be a provision where, if a trading company is representing a series of manufacturers, the trading company could be the DISC and then give that deferral benefit to the small manufacturers, so the trading company would be responsible for setting up the DISC, analyzing the export receipts and making sure that the DISC qualified. They could do all of the service on the DISC. Then the benefits could be accrued on a separate account like a trust account for each of the various manufacturers who might be participating——

Mr. NOWAK. Without the formation of individual DISC's.

Mr. REES. Yes.

Mr. NOWAK. To save them the time and the money.

Mr. REES. This way, the export company really is kind of the mother of the whole operation. I think a trading company should go to the Eximbank and get an overall line of credit and not have to go back to the Eximbank on every specific transaction. Then the Eximbank, of course, could audit the books every year to make sure that the loans were good loans. This way, the more of these you put into a trading company, the more viability you give to a trading company and the more incentive you have from the smaller manufacturers to go to that trading company.

Mr. NOWAK. We will incorporate that into the record.

[The information referred to above follows:]

Insert

THOMAS M. REES
ATTORNEY AT LAW, P. C.
1101 CONNECTICUT AVENUE, N. W.
WASHINGTON, D. C. 20036

(202) 223-6244

TO:

FROM: Thomas M. Rees

RE: SUGGESTED AMENDMENTS TO IRC DISC PROVISIONS

DATE: August 26, 1980

SUGGESTED AMENDMENTS TO IRC DISC PROVISIONS

A. Broadening the definition of for engineering architectural services for construction projects located outside of the U.S.

Explanation: §993(a) defines what are qualified exports which would qualify for DISC treatment. The definition is very narrow listing only engineering and architectural services. This does not cover the broad range of services which must be provided for overseas construction projects. The amendment lists the services which are normally part of a major overseas construction projects but which might be disallowed by the IRS if they took the narrow construction of the statute.

Amendment A: Amend IRC §993(a)(1)(G) to include the following within the definition of qualified export receipts:

"(G) gross receipts for engineering, architectural, project management, procurement, construction planning or mobilization services, or other services, such as financial administrative, clerical, data processing or reproduction services, which are related and subsidiary to any of the foregoing services for construction projects located (or proposed for location) outside the United States, and"

B. Easing the deemed distribution provision.

Explanation: If a DISC drops below the 95% level in their export receipts all the deferred assets from the time the corporation became a DISC are deemed to be distributed and liable to the 70% tax on unearned income. This is an extremely harsh penalty and has caused many small and medium sized companies not to use a DISC for their international transactions. Their export activities without the benefit of deferral become passive.

The proposed amendment provides that only the deferred income in the year the DISC failed to qualify are deemed to be distributed.

It should be pointed out that the company might have intended to reach the 95% level, but the IRS by audit might disallow what the exporter believed to be a qualified export receipt. Even if the item was relatively small, once the export receipt level fell below 95%, the DISC would be unwound by the deemed distribution of all its deferred assets. This could have serious, indeed catistrophic consequences to the parent corporation.

Amendment B: §995 Taxation of DISC income to shareholders

(b) Deemed distributions -

(2) Distributions upon disqualification

Strike in section(A), "or failed to satisfy the conditions of section 992(a)(1) for the taxable year". And add a new section following section B.

(c) A shareholder of a corporation which failed to qualify under the conditions of §992(a)(1) for the taxable year shall be deemed to have received a distribution, taxable as a dividend, equivalent to the shareholder's pro rata share of the corporation's income for that taxable year.

C. Increasing the limitation on deferral for small DISCS

Explanation: A small DISC is permitted to defer all of the tax on qualified export receipts if the adjusted taxable income is $100,000 or less. The amendment raise this threshold level to $1,000,000 with a phaseout between $1,000,000 and $2,000,000. Most exports are made by the largest companies, eg. the Fortune 100. There is need to encourage small and medium business to enter into international trade. The amendment is designed to encourage small and medium business which heretofor have not participated in international markets.

The language is taken from HR 1600 by Congressman Schulze (Pennsylvania).

SEC. 5. REMOVAL OF CERTAIN LIMITATIONS ON DEFERRAL IN CASE OF SMALL DISCs.

(a) GENERAL RULE.—Subsection (f) of section 995 (relating to small DISCs) is amended to read as follows:

"(f) SMALL DISCs.—

"(1) CERTAIN LIMITATIONS NOT TO APPLY.—If a DISC has adjusted taxable income of $1,000,000 or less for a taxable year, subsections (b)(1)(E) and (b)(1)(F)(i) shall not apply with respect to such taxable year.

"(2) PHASEOUT BETWEEN $1,000,000 AND $2,000,000.—If a DISC has adjusted taxable income of more than $1,000,000 but less than $2,000,000 for a taxable year, then the amount taken into account under subsection (b)(1)(E) or (b)(1)(F)(i), as the case may be, shall not exceed an amount which bears the same ratio to the amount which would (but for this paragraph) be taken into account under such subsection as—

"(A) the excess of the adjusted taxable income over $1,000,000, bears to

"(B) $1,000,000.

This paragraph shall be applied first with respect to subsection (b)(1)(E) and then with respect to subsection (b)(1)(F)(i).".

(b) TECHNICAL AMENDMENT.—Clause (ii) of section 995(b)(1)(F) is amended by inserting "(without regard to subsection (f))" after "under clause (i)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

Mr. **Nowak**. As we go along, we know the GATT-legal question will be reviewed during October in Geneva, so we will have more information in 1 month. The suggestions that I have noted so far, either from the administration or in the legislation, do not propose changes in the complexity and, in fact, in some instances, may make it more complex. I think that all the sponsors of those bills are ready and willing to look at some changes in those bills to make them simpler, especially since we have tried to impress upon them the problems encountered by small- and medium-size businesses in trying to get into the exporting business.

We may be back to you as we pull all of this together, and there may be other questions. What we want to do is present a very well-defined, if you will, background paper or document to the Ways and Means Committee and others in this field to pull together a large consensus of the small- and medium-sized business community that is represented out there, not only by individuals, but by associations as well.

Do you have a question?

Mr. **Centner**. Yes. I would like to ask Mr. Rees his reaction to one of the other witnesses' testimony.

One witness made the comment the DISC is good for small business because they can make out in the area of subcontracts. That sounds a little bit like suggesting that somebody would want to grow up to be Vice President. I wonder whether you didn't really hit the key point on the head when you said that we are always looking for one solution, that perhaps the question isn't simply DISC or something else, that perhaps it is DISC, plus something else.

I was a little bothered by the fact that one of the witnesses we had earlier made this comment:

> Government can best assist by providing tax incentives as well as the regulatory legal reciprocal trade framework in which business can operate. Beyond that, business is capable of recognizing the incentives and maximizing them on their own. As a result—he is talking about small businesses now—DISC has a much higher priority in interest for our members than Government-sponsored information, counseling or market analysis programs, Government assistance in developing distributors, Government-sponsored trade shows or similar programs.

That is not what we are hearing from small businesses in Utah who say just the opposite. I wonder, getting back to your key point again, "DISC plus" rather than "DISC or," how would you respond to that kind of comment?

Mr. **Rees**. I would respond by saying if you analyzed DISC beneficiaries, they are basically the largest corporations in America today, and that the small and medium businessmen don't really go into DISC because of its complexities.

You mentioned trade shows. I am very big on trade shows. A medium-size businessman wanting to participate in the Milan show—if he goes there himself and is taking a couple of weeks off and paying for his plane fare—is making a fantastic commitment. But when he is asked to pay $4,000 or $5,000 to rent space, it makes it impossible. Now, I think trade fairs are tremendous. I have been to trade fairs where there were 10,000 or 15,000 visitors from all over the world. Big trade fairs represent a fantastic opportunity for marketing because you meet everybody there in one place and you can really give them the information that they want.

I just don't think DISC is being utilized by small business because of the complexities. A lot of times, the biggest problem with small business is not deferring income. I do a lot of income deferring and I do a lot of tax work. It is great to talk about deferring income, but if you don't have any income, you can't defer it.

DISC is important, but what I would consider far more important is financing. What you are dealing with is an exporter's money. Most of the export traders I know are very short of money, and their bank credit is extremely tight.

When I first started business, I would sell something in Mexico and then I would get my letter of credit or sight draft and I would get money, and then I would work on my second deal. It would take me 3 weeks to do that, so I was only working one deal every 3 weeks on major equipment. If I had a revolving line of credit so that I make my sale, and make another sale with a revolving line of credit where you could turn your deals over quickly, discount that paper right away. We thought maybe they should have a discount window at the Eximbank of the Fed. You could take your paper, discount it, and use your money again.

I think this is more important than DISC. I think DISC is important, but you must make money before you can defer it. A lot of times, you don't want to defer it because, frankly, as a small business, you need it right there.

I would have different priorities. For small and medium businessmen who do not understand trade, the complexities, and the risk problems you have—there are tons of risks, and the biggest one is on currency right now—they need help. They need someone who really understands this. They have to find out if you can buy financial futures, for example, to cushion your deal. When you get in the financial futures market that is very complex, buying 30, 60, 90 days forward.

I think basic credit and someone to lead you through a transaction is important. As I say, DISC is also important, but in terms of who has been using it, the small businessman has not.

Mr. NOWAK. You would rather have the cash.

Tom, thank you very much. Again, we will be back to you as we try to fill in some of these other broadening incentives along with this DISC program.

Mr. REES. Thank you very much, Mr. Chairman.

Mr. NOWAK. What I would like to do, in the interest of time—our schedule has been a little bit ambitious—is have the three last witnesses come to the table together. We have the Smaller Manufacturers Council of Pittsburgh, with Leo McDonough, executive vice president, who has been with the association for 15 years. He, like the previous witness, has also been active in the White House Conference on Small Business.

We have also with us Alexander Zakupowsky, Jr., a partner with the international accounting firm of Deloitte, Haskins & Sells. Mr. Zakupowsky has firmwide responsibility for all of its tax policy matters.

The third is from the Smaller Business Association of New England, John C. Rennie, vice president of that association and member of SBANE's international trade committee. He is also president of Pacer Systems, which manufactures flight simulation equipment and airspeed measuring systems for helicopters. So we have a broad sector here.

Mr. McDonough, why don't you start. All of your testimony, in the interest of time, will be incorporated in the record. We will try to ask joint questions, if we can. If you will summarize your information, I think the detail work will be done.

PANEL CONSISTING OF LEO R. McDONOUGH; JOHN C. RENNIE; AND ALEXANDER ZAKUPOWSKY, JR.

TESTIMONY OF LEO R. McDONOUGH, EXECUTIVE VICE PRESIDENT, SMALLER MANUFACTURERS COUNCIL, PITTSBURGH, PA.

Mr. McDONOUGH. Thank you, Mr. Chairman. I appreciate the opportunity to be here. I won't go through the litany of our organization and the commercials that go with that type of litany.

Mr. NOWAK. It will show up in the record.

Mr. McDONOUGH. Thank you.

I am substituting for the president of our council, Mr. Frank Fairbanks, of Horix Manufacturing Co., who couldn't be here because of an illness in his family. Thus, my testimony was sort of a quick put-together of trying to get some facts from some of our members who had DISC. Some of them may sound very insignificant by numbers, but yet to them, it is a very important piece of their business.

SMC is a trade association representing over 1,500 small businesses with 90,000 employees. SMC is a charter member of Small Business United, a coalition of regional small business groups representing 32 States. SMC is also a member of the Coalition of Small and Independent Business Associations—COSIBA—which is composed of grassroots regional small business groups and five of the largest small business associations based in Washington, D.C. Under this coalition we represent approximately 5 million small businesses.

I would like to tell you about a few small businesses I'm closely connected with, and what their DISC means to them.

David Leonard of Sauereisen Cement Co. has 30 employees, and 25 percent of his business is involved in DISC. He feels that only two jobs would be involved, as far as his company is concerned. He feels the advantages are deferred income tax which improves his cash flow, which can be used to expand business, and in turn increases the number of employees, property, and equipment. It also helps to ease the overburdened borrowing problem and helps the business climate. There is no risk involved in the program.

Frank Speicher of M. E. Cunningham has 57 employees, is a 15-percent DISC, and has 8 jobs dependent upon it. He feels it is an incentive for exporting sales, that it is simply an uncomplicated system.

Paul Hankison, of Hankison Corp. has 190 employees; 10 percent of them are involved in DISC, which equals 19 jobs. Deferral of income tax, which improves cash flow. It also increases sales due to the incentive of savings and increased profits.

Herb Cable, Weld Tooling Corp., has 50 employees, 40 percent DISC, or 20 jobs. His idea was that perhaps we should do something like they do in Australia where, once the bank receives the shipping papers, you are paid immediately, and that a system like this might get the money to the small businessman in a much quicker way, similar to the idea that I heard Tom Rees talking about.

The most interesting one I came across just last night and made it part of my testimony. Roger Gettys Hill, is president of Gould, Inc., from Racine, Wis. He had a DISC with 100 jobs. He operated for 4 years. The IRS came in the first 3 years and everything was fine. They came in the fourth year and they said that the percentages weren't right, so they hit him for $400,000 in back taxes. He was able to appeal and get it down to $100,000 in taxes. This was on the deemed distribution feature. He was so upset with the whole idea, he discontinued his DISC, went over to Ireland and opened a plant there and moved 100 jobs to Ireland.

I think that is one of the things we have to think about when we are talking DISC or any other incentives, the jobs that small businesses generate and the loss of jobs when anything like this is taken away from small business.

I have included as part of my testimony the final analysis on the White House Conference on International Trade talking about DISC. I will just include that instead of discussing it.

[The material referred to above follows:]

WHITE HOUSE CONFERENCE ON SMALL BUSINESS

TRADE AND THE DOMESTIC INTERNATIONAL SALES CORPORATION

Congress should broaden the tax deferral options of the Domestic International Sales Corporation and provide for the development of an American Trading Company which would automatically qualify as a DISC. Tax deferral options should include the following additional provisions for DISC's: (1) allow for deduction of twice the moneys expended for participating in any bona fide overseas trade fair by a DISC; (2) allow for the deduction of twice the amount of premiums paid to Eximbank and FCIA, as legal deductions prior to payment of DISC taxes; (3) increase the $100,000 exemption clause to $500,000; (4) provide for a graduated tax on "deemed distribution" from $500,000 for $50 million, and a standard rate of 50 percent levied on over $50 million; (5) exempt new DISC's from any "deemed distribution" requirement for a least the first three years of operation; and, (6) provide for the elimination of existing incremental provisions of DISC regulations. Congress should provide within the tax structure an "Exporter's Allowance" or tax deduction which would apply in the trade of all goods abroad by granting an allowance for 75 percent of the marketing expenditures incurred by the exporter.

Eximbank should establish a special small business founding program through commercial banks, and should consider discounting loans to support international sales and should develop a cooperative program with the SBA for pre-export financing.

The Federal Government should establish field on-stop service shops to include export services of all Federal agencies under the guidance of the Department of Commerce.

The President and Congress should consolidate under an existing cabinet level department, a unified would trade administration. It would be responsible for all trade policy functions of the various agencies and departments. Its objective would be to maximize the international competitive strengths of U.S. Small Business with support and goals for minority, women-owned and disadvantaged business and specific programs developed to utilize their units of, technological, educational, cultural, language and political expertise.

Congress should provide for support and expand the use of all officially recognized trade fairs, exhibits, and trade centers abroad with small business participation;

continue to encourage the Department of Commerce to increase the promotion of foreign buyer and foreign visitor travel to the United States; and develop a program utilizing the cultural, language and political expertise of all Americans, especially ethnic groups, to assist in preparing, implementing and utilizing a sales package for use in expanding international trade in all world markets.

Mr. McDONOUGH [continuing]. We also in our testimony refer to the Price Waterhouse study that was done. The study estimates that U.S. exports would have been $5.3 billion lower in 1979 if the DISC incentive had not been in place. Looking at the probable direct corporate income taxes, personal income taxes, and payrolls that result from such sales, Price Waterhouse documents show that the DISC actually returns $1.24 to the Treasury for each dollar of tax incentive provided.

[The material referred to above follows:]

ACCOUNTANTS SAY DISC IS A MONEYMAKER

A 75-page report from Price Waterhouse's Economic and Regulatory Services says that the domestic international sales corporation (DISC) export incentives actually save the U.S. Treasury more than they lose. "Rather than costing the taxpayer," Price Waterhouse says, "DISC actually returns $1.24 to the Treasury for each dollar of tax incentive provided."

The Price Waterhouse report was undertaken at the request of six organizations representing U.S. trade interests, including the U.S. Chamber of Commerce, the Business Roundtable, and the Special Committee for U.S. Exports. According to Price Waterhouse, "These organizations and the business community have been challenged by Treasury officials to demonstrate the cost-effectiveness of DISC and were asked to prepare a report that *quantifies* the costs and benefits of DISC."

A SUPPLY SIDE EXERCISE?

The Price Waterhouse report begins with the figures shown in Treasury's 1979 annual report on the operation of the DISC legislation. (That report, which was published in April 1981, is in the *Tax Notes Microfiche Data Base* as *Doc 81-4441.)* In that report, Treasury concluded that DISC had increased U.S. exports between $4.5 and $7.0 billion at a cost to Treasury of $994 million.

Price Waterhouse challenges these Treasury figures as too high. It concludes that the direct cost of DISC to Treasury was $833 million in 1979, rather than $994 million. In addition, it chastises Treasury for failing to take into account the "feedback effects" of DISC, including $161 million in additional corporate income taxes, $451 million in personal income taxes, and $420 million in payroll taxes. Given these feedback effects, Price Waterhouse concludes that DISC more than pays for itself.

An independent economist contacted by *Tax Notes* was critical of this use of "feedback data" by Price Waterhouse. "This looks like the ultimate supply-side exercise," he said. "If we didn't have DISC," he added, "the resources now attracted to the export sector by the availability of the DISC tax breaks would be employed elsewhere, and probably more efficiently. Hence, it's not legitimate to attribute those feedback effects to DISC."

The Price Waterhouse report states, however, that in the current slack economy this criticism may not be valid. "Assuming that resources used in the production of DISC-induced exports were previously unemployed—a plausible assumption in today's economy—and the DISC-stimulated exports represent a net increase in the U.S. balance of trade, DISC will add to the aggregate output of the U.S. economy and U.S. tax collections," the report says.

DOCUMENTS AVAILABLE

The full text of the 75-page Price Waterhouse report on DISC is in the May 17, 1982 *Tax Notes Microfiche Data Base* as *Doc 82-5643.* Alternatively, it can be obtained through the *Tax Notes Complete Access Service* (see inside cover page).

Set forth below is the full text of the "Executive Summary" included in the Price Waterhouse report.

EXECUTIVE SUMMARY

The purpose of the Domestic International Sales Corporation (DISC) tax provisions is to enhance the ability of U.S. firms to compete in the world marketplace. The two primary effects of DISC are to:

Increase export sales by the U.S., and

Decrease tax receipts from export sales that would have occurred in the absence of DISC.

The U.S. Treasury, in its 1979 DISC Annual Report, estimates the magnitudes of these effects as follows: $4.5 to $7.0 billion in DISC-induced export sales, and $994 million in reduced tax revenues.

The purpose of the study performed by Price Waterhouse is to examine the economic impacts of DISC, in particular the estimated magnitudes of DISC-induced export sales, and the cost of DISC to the U.S. Treasury.

In brief, our findings are:

Treasury estimates understate the likely range of values for DISC-induced export sales. Our analysis suggests a range of $1.5 to $7.0 billion, with a moderate response estimate of $5.3 billion.

Treasury estimates of DISC costs include foregone corporate taxes on both existing and DISC-induced export sales. Since the true cost of DISC is the amount of taxes foregone on existing export sales, the Treasury estimate of the cost of DISC ($994 million) should be reduced by $161 million under a moderate response scenario (to $833 million).

Assuming a moderate response estimate of $5.3 billion in DISC-induced exports, and current slack conditions in the U.S. economy, the following effects are observed: $161 million increase in corporate income taxes; $451 million increase in personal income taxes; and $420 million increase in payroll taxes.

In summary, we conclude that the Treasury estimate of DISC costs of $994 million should be reduced to $833 million and should be further reduced by the following DISC-induced tax collections:

Type of Tax:	(Millions)
Corporate income taxes	$161
Personal income taxes	451
Payroll taxes	420
Total	1,032

Source: Tax Notes, May 17, 1982, p. 585.

In other words, rather than costing the taxpayer, DISC actually returns $1.24 to the Treasury for each dollar of tax incentive provided.

Thus, we conclude that the DISC provisions increase U.S. export sales by between $1.5 and $7.0 billion at little or no cost to the Treasury. In fact, under a reasonable set of assumptions, DISC may actually *increase* both *output* and total Treasury *receipts* at a time of low capacity utilization and high unemployment in the U.S. economy.

I think, speaking from my years of testifying on behalf of small business, the most frustrating part of that testimony is, when we talk about any type of rules, regulations, taxes or anything else involving Treasury, they immediately say, "How much is it going to cost?" They say, "It is going to cost this much, but it is going to return this much." They say, "We don't want to hear that." They just will not take into account what the return on the dollar is, but they take into account what the cost is, which makes it awful tough to win any kind of an argument with OMB or with the Treasury.

I have also included a paper which was submitted to Richard McIlheny, Deputy Assistant Secretary of the U.S. Commercial Service. This was done by district export councils in different parts of the country where they were asked to submit suggested ideas on DISC and replacements for DISC. It is 10 pages, and I won't try to read it now, but there are some excellent suggestions in there as to ideas that perhaps—and these are by people exporting—they may feel would help offset some of the losses of DISC or replace some of the ideas of DISC.

Mr. NOWAK. When was that submitted?

Mr. McDONOUGH. This was submitted August 7, 1981. It is a memorandum from W. H. Morris, Jr., Assistant Secretary for Trade Development from Richard McIlheny, and the subject is "Alternatives for Domestic International Sales Corporations." I will submit that into the record.

[The material referred to above follows:]

U.S. DEPARTMENT OF COMMERCE,
INTERNATIONAL TRADE ADMINISTRATION,
Washington, D.C., August 7, 1981.

Memorandum for: W. H. Morris, Jr., Assistant Secretary for Trade Development.

From: Richard L. McElheny, Deputy Assistant Secretary for the U.S. Commercial Service.

Subject: Alternatives for Domestic International Sales Corporations (DISC's).

During Secretary Baldrige's recent testimony before the Senate Banking and Finance Committee, several Senators expressed concern that the Commerce Department should have alternatives if we lose DISC's. In response, the USCS requested a number of District Export Councils to identify some possible alternatives to the DISC.

We have prepared both a summary and a complete listing of the alternatives offered by the Councils. Copies are attached. Some of the councils continue their strong support for retention of the DISC program with certain improvements and some assuming DISC's were eliminated, pointed out that by current tax law, all remaining untaxed income would be taxable to DISC shareholders in one year. This would, according to the respondents, result in a tax burden which would have too great an impact on the financial structure upon a company which is a current DISC shareholder. A majority supported in principle the plan proposed by Deputy U.S. Trade Representative MacDonald and reported in the July 15 issue of The Wall Street Journal (See attached).

We also were provided with the names of persons (mostly DEC members) who are prepared to provide the Secretary, Trade Development or International Economic Policy with additional comments reflecting their organizations' views of the DISC program, and possible alternatives. Many of these persons have indicated they would visit the Department to help develop and/or refine the alternatives suggested.

We feel that each person who has offered an alternative and/or their services should receive an appropriate letter from yourself or the Secretary. We will be happy to prepare the letters. Further, the Secretary might instruct the appropriate ITA staff to follow up on the suggested alternatives and, where appropriate, consult with the person to refine the alternative. USCS would be pleased to serve in a supporting capacity if requested to do so.

A complete list of persons and their organizations is also attached.

Alternatives to Domestic International Sales Corporation (DISC)

A tax credit, or a Federal Income Tax rate lower than the stated rate, on export income.

Suggested by Charles A. Berthy
Chairman
Southern Ohio District Export Council

A viable incentive is needed to enter the export market. Cash flow is a perpetual problem with small business firms interested in exporting. Only tax incentives will aleviate the situation, such as double deductions for export market expenses, tax forgiveness on a portion of total gross income, when that portion is utilized in export activities.

The suggestor also states that the proposal developed by Deputy U.S. Trade Representative MacDonald appears to be a more workable and acceptable plan than the DISC, but should not replace DISC unless a mechanism is provided to waive all currently deferred taxes now on the books of DISC members.

Suggested by Jerry D. Maahs, Chairman
Wisconsin District Export Council

I recommend the following proposal to Secretary Baldrige as a sustained and long term incentive program to stimulate U.S. export sales. This proposal emphasizes new investment and reinvestment of export earnings; it rewards profitable export sales and avoids subsidies to non-profit export activities. This proposal will benefit either small or large export businesses.

Proposed Export Development and Investment Act

New Investment in Export Company

Future export earnings up to the sum of new export investments shall be exempted from tax.

Reinvestment of Export Earnings

When fifty percent of pre-tax export earnings are reinvested in export development and support activities, a preferential tax rate of twenty-five percent shall apply. The preferential tax rate shall decrease by equal percentage points of increased reinvestment (above 50% of pre-tax export earnings). Zero tax rate on export earnings is reached when seventy-five percent of export earnings are reinvested in export development and support activities.

Definitions

Export Company

Ninety-five percent of company's sales are exported to foreign destinations from U.S.A. or to another company in U.S.A. for subsequent export to foreign destinations.

Export Development and Support Activities

1. R and D activities on exportable products and services.
2. Foreign market development.
3. Investment in capital equipment and tooling for the manufacturing of exportable goods and systems.
4. Financing and insurance expenses of export sales.
5. Filing and maintenance of foreign patents and trademarks for the protection of U.S. technology.
6. Expenditures for the compliance of foreign codes and regulations applicable to the exported U.S. goods and services.

Suggested by Donald J. L. Lin, President
Forney International, Inc.

It would appear the only viable alternatives that would be acceptable to GATT would be:

1. World Trade Corporation. The Administration's proposal for a foreign based company which handles exports whose income would be taxed but at a zero rate. For ease of administration, recommend acceptability of commission arrangements with world trade corporation as opposed to necessity to buy and sell. Similar proposal has been made by Senator Ribicoff.
2. Eliminate present system of currently taxing earnings of U.S.-controlled corporations.

While I would favor more direct tax incentives to spur the growth of U.S. exports, it would appear an alternative to DISC that is acceptable to GATT has to be along the lines of items 1 and 2 above. While value added tax rebates in some

European countries are apparently acceptable under GATT rules, we should not adopt an additional tax in the absence of concurrent legislation to eliminate or reduce present taxes.

While not directly related to DISC, other considerations to improve U.S. world trade are:

1. Encourage the IRS to recognize purpose of foreign tax credits is to prevent double taxation.

   Eliminate restrictive regulations which do not allow credits for foreign tax reasonably intended to tax income.

2. Improve Tax Climate. For research and development expenses by eliminating allocations to foreign source income under Section 861 regulations.

3. Remove Disincentives to Exports:

   a. Anti-Boycott Rules.
   b. Foreign Corrupt Practices Act.
   c. Restrictive Section 861 regulations which reduce foreign source income for foreign tax credit purposes.
   d. Taxation of Americans working abroad to sell U.S. manufactured products.
   e. State's unitary taxing method whereby foreign source income gets arbitrarily swept into the state's tax base.

Suggested by James B. Graves
Senior Vice President-
Corp Planning
Dresser Industries, Inc.
Elm at Akard
Dallas, Texas 75201

We believe that the present DISC legislation is serving the purpose for which it was enacted, i.e., to (1) encourage U.S. exports and (2) allow U.S. companies to compete in the worldwide market place with non U.S. producers. We recognize, however, that the DISC legislation in its present form has attracted substantial criticism due to its apparent violation to GATT regulations.

4.

For these reasons, PPCo suggests the following alternative. Enact legislation to:

1. repeal the present tax which is imposed on the shareholder of a DISC;

2. impose the tax directly on the taxable income of the DISC but at a rate which is commensurate with the present effective tax rate imposed on shareholders of a DISC. All (in lieu of one-half under present law) of the DISC's taxable income (as presently computed) would be subjected to U.S. tax but at a lesser rate, e.g., a 23% rate. This could be accomplished by a special deduction similar to that provided for in the Western Hemisphere Trade Corporation provisions (Sec. 922(a) of the Internal Revenue Code) which has now been phased out. This special deduction could provide for a tax rate of 23% of DISC's taxable income.

Most of the other current DISC provisions could be retained, except that legislation would need to be provided to allow the DISC to pay dividends to its parent without incurring additional U.S. taxes.

We believe our proposal, as briefly outlined continues to serve the original purpose for which DISC legislation was enacted and apparently negates the criticism from GATT which was alluded to previously.

Suggested by Leo H. Johnstone
Phillips Petroleum Company
18th Floor Phillips Building
Bartlesville, OK 74004

A straight-forward and relatively uncomplicated approach would be to allow a tax credit equal to a percentage, probably 50%, of that portion of the tax generated upon net income attributable to exporting of goods and providing services in foreign countries.

A variation of the above would be to provide a credit of 30%, for instance, of the tax attributable to such net income equal to last year, and a credit of 60%, for instance, of the tax attributable to the increase of such net income over the prior year, or over an average of several prior years.

5.

To avoid the administrative and calculating costs that would result from allocating expenses and other deductions to determine net income from foreign purchases of goods and services, the tax payer might be permitted, for purposes of applying the credit, to determine the amount of such net income (and the tax thereon subject to credits) by determining what part of total gross revenues was received from foreign purchases of goods and services.

Cessation of DISC is going to require more than merely providing that current DISC's no longer have the election. Present DISC law provides that upon the disqualification of a DISC, the untaxed income is to be returned to the shareholders over a defined period of time. This feature of the law should be continued. If it is not, such would mean that all untaxed income would become taxable to DISC shareholders in one year. This would result in a tax burden which would have too great an impact upon the financial structure upon a company which is a DISC shareholder, and would skew the current financial picture for such a shareholder.

Suggested by A. J. Greffenius
Attorney at Law and Member
Iowa District Export Council

In order to develop reasonable alternatives to DISC one must address the specific GATT objectives and develop alternatives which meet said objections. To this extent, of course, without more information on the GATT objections any alternatives proposed might also be unacceptable to GATT. Secondly, since DISC is by design an income tax incentive to exporting, I propose to limit my suggestions to alternative tax incentives. However, there may be non-tax incentives available, such as preferential government sponsored loan programs to exporters, which might also be considered.

One alternative would be to allow a special deduction based on export activity. For example, a deduction equal to a percentage of export sales could be allowed in computing taxable income. While somewhat more complicated, the deduction could alternatively be based on gross profit or net income from export activity. By way of analogy I refer you to the Western Hemisphere Trade Corporation provisions which used the special deduction approach.

Another alternative would involve the allowance of a tax credit. As with the special deduction the credit could be computed on the basis of sales, gross profit net income or some other factor which would recognize the quantum of export activity.

A third approach would involve amending the present DISC provisions to eliminate the indefinite deferral aspect and replace it with a specific time frame for deferral. For example, the income tax resulting from the export activity could be deferred for some specific number of years. This could be accomplished in at least two different ways. One would involve computing the income tax related to the export activity in any given year and rather than pay it currently provide that it is payable over some specific number of years. An alternative to this approach would be to require that the income from export activity be computed on an annual basis but provide that it is to be taken into taxable income over some specified number of years. As an example of how this approach would work, I refer you to the present tax provision relating to a change in accounting method. While the total amount of income or deduction resulting from a change in accounting method must be computed in one taxable year, the amount of the adjustment is generally taken into income one-tenth per year over a period of ten years. Either of these approaches results in more certainity to the taxpayer as well as the U.S. Treasury while providing an incentive to exporting.

In addition to the above, there are perhaps amendments to the current DISC provisions which might meet the GATT objections but continue to provide continuing benefits to the exporter.

Regardless of the alternatives to DISC which might be utilized, the termination of DISC should also be considered in terms of all of the present users of DISC and the impact on them. To accelerate the taxability of the present deferred DISC income into one or even a few years, could cause serious problems for the taxpayer. Thus, the phasing out of the DISC may be as an important decision as the finding of an alternative.

Suggested by Jerry Chicoine
Partner
McGladrey Hendrickson & Co.

1. A permanent tax reduction on export earnings, along the lines embodied by the now-repealed Western Hemisphere Trading Corporations provisions (IRC §§ 921-922), as suggested in the Wall Street Journal on July 15, is very attractive but probably not realistic in terms of extant Congressional attitudes and the revenue loss emanating-from such a reduction.

2. Taxation of export earnings could be effectively deferred by removing sales of U.S. manufactured goods and services from the ambit of "foreign base company income" as presently defined in

Subpart F of the Internal Revenue Code (IRC §954) which otherwise is deemed distributed to the U.S. parent (IRC § 951) and therefore currently includable as income to the U.S. parent. This change could be readily effected by amending Section 954 or by revitalizing Export Corporations (IRC §§970, 971), or both.

Export Trade Corporations are defined as controlled foreign corporations at least 90% of whose income is foreign income and at least 75% of whose income is export trade income (50% in the case of agricultural exports) derived from sales to unrelated persons for use outside the U.S. and service fees, royalties, and interest on receivables related to such sales. Under present law, no controlled foreign corporation may qualify as an Export Trade Corporation which was not qualified as such for a tax year prior to October 31, 1971, and in any case, the reduction of its Subpart F income is limited to the smallest of (a) 1.5 times its export promotion expenses; (b) 10% of its gross export receipts; or (c) the increase for the year in its investment in export trade assets (IRC §970).

By reactivating the Export Trade Corporation, deleting the requirement that sales be made to unrelated persons, and removing the severe limitations on its Subpart F income deferral, we believe that the Administration would be offering a significant tax incentive to U.S. exporters in lieu of DISC without running into substantial opposition from the Congress or from the GATT. It would appear as well to complement the Export Trading Company legislation under Congressional consideration.

Suggested by John R. Liebman, Esq.
Grossman Graven Perry & Liebma
One Wilshire Building
Suite 2420
Los Angeles, CA 90017
and
Neal W. Zimmerman, CPA
Price Waterhouse & Co.
606 South Olive Street
Los Angeles, CA 90014

New tax legislation similar to the old Western Hemisphere Trade Corporation (WHTC). The new legislation should be on a worldwide basis. It should cover the export of products, revenues from engineering, design, and similar consulting fees. By taxing these revenues at a reduced corporate rate, it would enable U.S. corporations to price their products and services at a lower rate and become more competitive.

Suggested by Pittsburgh District Export Council

8.

Allow U.S. firms to establish export trading company and defer taxes on 100% of export earnings. At such time as taxes are to be paid, go on a sliding scale considerable less than the normal rate. For example, the first $1 to $5 million at a rate of 1% to 5%, the next $5 to $10 million at a rate of 5% to 10%, etc.

Suggested by Milton Fisher, Chairman
Florida District Export
Council

Remove Eximbank from Foreign Assistance Act. Set up under Treasury Department as a Government Corporation.

Provide tax break for new export trading companies for two years.

The Department of Commerce should support U.S. exporters who are actively developing new markets for their products and/or services by keeping the costs of Commerce services to an absolute minimum. Consideration should also be given to underwriting up to 50% of the costs involved in exhibiting American products at official trade shows overseas.

Suggested by Michigan District Export
Council

Names of Persons and Organizations Offering Alternatives to DISC or their Assistance

Alternatives

* Charles J. Berthy
Vice President and
General Manager
International Division
Ledex, Incorporated
P.O. Box 427
Vandalia, OH 45377
(513) 898-3621

* A. J. Greffenius
Attorney at Law
2300 Financial Center
Des Moines, IA 50309
(515) 243-2300

* Jerry Chicoine, Partner
McGladrey Hendrickson and
Company
300 Financial Center
Des Moines, IA 50309
(515) 284-8660

* Jerry D. Maahs
President
Alto-Shaam, Inc.
W164 N9221 Water Street
Menomonee Falls, WI 53051
(414) 251-3800

* Henry F. Stevens
Stevens and Associates
635 Elm Street
Birmingham, MI 48011
(313) 642-6558

* Milton N. Fisher
President
Panelfab International
1600 N.E. LeJeune Road
Miami, FL 33126
(305) 871-2100

* George C. Oehmler
Vice President, International
Allegheny International, Inc.
Two Oliver Plaza
P.O. Box 456
Pittsburgh, PA 15230
(412) 562-4125

* John R. Liebman, Esquire
Grossman Graven Perry and
Liebman
One Wilshire Building
Los Angeles, CA 90017
(213) 680-9770

* Neal W. Zimmerman, CPA
Price Waterhouse and Company
606 South Olive Street
Los Angeles, CA 90014
(213) 625-4468

* James B. Graves
Senior Vice President -
Corporate Planning
Dresser Industries, Inc.
Elm and Akard
Dallas, TX 75201
(214) 746-6723

* Donald J. L. Lin
President
Forney International, Inc.
P.O. Box 189
Addison, TX 75001
(214) 233-1871, Ext 441

* Leo H. Johnstone, Jr.
Director and Executive Vice
President
Phillips Petroleum Company
Room 18 Phillips Building
Bartlesville, OK 74004
(918) 661-6600

* Member of District Export
Council

Offering Assistance

* Herbert E. Cable, President
Weld Tooling Company
3001 West Carson Street
Pittsburgh, Pa 15204
(412) 331-1776

Henry Fish, President
American Sterilizer Company
2222 West Grandview Boulevard
Erie, Pa 16512
(814) 452-3100

* Richard A. Shimko
Vice President, Dravo International
Dravo Corporation
One Oliver Plaza
Pittsburgh, Pa 15222
(412) 566-3529

* Milton E. Berglund
Vice President
Mellon Bank, N.A.
Mellon Square
Pittsburgh, Pa 15230
(412) 232-6292

Joseph F. McCaddon
Director of Exporting - Europe and Middle East
Rockwell International
600 Grant Street
Pittsburgh, Pa 15219
(412) 565-7112

* Grant J. Wilsey
Vice President
International Operations
Viking Pump Division
Houdaille Industries, Inc.
Cedar Falls, Iowa 50613
(319) 266-1741

* James L. Stott, Jr.
Vice President and Manager
Bank America International
Minneapolis Branch
121 South 8th Street
Minneapolis, Minnesota 55402
(612) 343-2400

* Neil J. Boyer, Esquire
Willard & Nusbaum
275 Post Road East
Westport Ct 06880

* William J. H. Foster
Senior Vice President
Union Trust Company
300 Main Street
Stamford, Ct. 06904
(203) 348-6211

* Roger D. Cannon
Export Sales Manager
The Barden Corporation
Park Avenue
Danbury, Ct 07810
(203) 744-2211

* Robert B. Wassung
Vice President, International
The Torrington Company
59 Field Street
Torrington, Ct 06790
(203) 482-9511

* Frederick G. Auch
CR Industries
900 N. State Street
Elgin, Il 60120
(312) 742-7840, Ext 574

* Frank P. Baxpehler
Vice President, Marketing
Ludwig Industries
1728 North Damen Avenue
Chicago, Il 60647
(312) 276-3360

* Larkin N. Hall
Senior Vice President
Deere and Company
John Deere Road
Moline, Il 61265
(309) 752-8000

* Clyde E. Dickey, Jr.
Arthur Andersen and Company
33 West Monroe Street
Chicago, Il 60603
(312) 580-0033

* Member of District Export Council

Offering Assistance (cont'd)

Richard Hoefs
Tax Partner
Arthur Andersen and Company
33 West Monroe Street
Chicago, Il 60603
(312) 580-0033

* Mack Verhyden
Vice President
Caterpillar Tractor Company
100 N.E. Adams Street
Peoria, Il 61629
(309) 675-4469

* Member of District Export Council

I would like to wrap it up. I saw the movie yesterday, and I am sure some of the people saw it on the internal system here in the House, on Japan and the shootout between Japan and America. If you didn't see it then, you may have seen it originally. They used in that thing a couple of points that really hit me between the eyes when we are talking DISC or talking exporting. One was the definition of a colony, a country that exports raw material and imports manufactured goods. Boy, I would hate to think that that is the direction that we are heading in, but it looks like more and more that is the direction we are heading in.

In Japan, the Government and business have cooperation; in America, we have confrontation. In Japan, they have got 2 percent unemployment; we have got 10 percent unemployment.

I would push on the point that small business is a job creator, and any incentive that is taken away from small business makes it just that much more difficult to create jobs. Small business needs capital. It usually comes up as its number one problem. This is one way that they have been able to use capital and to be able to have money at their use to enlarge and to increase jobs.

The other thing that bothers me is it seems that every time that any kind of a break comes along, if you call it a break—and I would say that DISC is definitely a break for those who are using it and it is working—somebody comes along and wants to take it away. The saddest part of that is that many times when these incentives are brought up, the job tax credit, for instance, it is in operation for a year or two before small business even catches up to it. DISC was in operation for a couple years before small business even knew it existed, because we don't have the luxury in most instances, unless it is a very successful small company, of having a Big 8 firm who can call to our attention something like this. Our accountants, in most cases, don't even know what a DISC is and don't understand what the initials stand for.

So it is in operation for a few years before one of our guys finds out about it, and he comes to the next meeting of our association and he starts telling everybody about this great new thing his accounting firm told him about, and then it takes them 6 months to investigate it and get into it and try to get it started. And just about the time they spend that money and start to make it pay back a little bit, somebody comes on with a great idea that that is not nice because that is a loophole and we shouldn't be given loopholes. Sometimes I think we need incentives, whether you want to call them loopholes, breaks, or whatever.

DISC was meant to stimulate small business and get them into exporting. In our organization, we started a group called the Export Profits Council about 5 years ago. We used five or six of our members who were exporters. We set up a steering committee with them and we meet once a month, and we bring in speakers with the help of the Commerce Department to teach our people how to export, those who might want to get into it. We were told this was very patriotic because we were taking a beating on the balance of trade and the more companies that we could get into this, the better job we would be doing for our people and the better job we would be doing for our country and everybody else.

Our leaders, some of the ones I have already mentioned, took a leadership role in this. They showed up week after week at these meetings going over very basic material that they knew inside and out because they had been doing it for years. But they were willing to give their time to try to teach their fellow small businessmen how to go about exporting and how to get into it.

The one thing that was mentioned before, the one-stop service. Our State has done that for small business. We have now what we call a small business action center in Harrisburg, and anybody in Pennsylvania who has any kind of a problem for small business can make a phone call and that action center will get an answer for them. That seems to me to be an excellent suggestion, and that came out of the White House Conference also, to put together something that would have a direct result, where somebody could pick up a phone and have a hot number and they could get the answer they need.

One thought we had perhaps is if they were going to do away with DISC—and it is almost beginning to sound like it has to be, and I don't know why—then I would say we should then perhaps go back to reinstating the job tax credit and make some allowances for the jobs that are tied into DISC so that all small business, not just those with a DISC, would be able to take advantage of a job tax credit and put more people to work. But under no circumstances can we afford to do away with DISC until an equal or better alternative for small business can be put into operation.

A closing thought I have is that companies, especially small companies, can't compete with nations when it comes to exporting. Coming from Pittsburgh where we have over 20,000 steelworkers unemployed because of competition from overseas, my heart doesn't bleed too much for the people who are complaining that DISC is too much of a break. I think we need some breaks just to get back some of the ground we are losing in some other areas.

Thank you.

Mr. **Nowak**. Thank you very much.

[Additional submissions of Mr. McDonough follow:]

PREPARED STATEMENT OF FRANK FAIRBANKS, PRESIDENT, SMALLER MANUFACTURERS COUNCIL, AND PRESIDENT, HORIX MANUFACTURING CO.

When we at Horix try to sell machinery to Mexico or South American countries, we are not only competing against other U.S. manufacturers but also against European machinery manufacturers. The advantageous financial terms which some European governments make available for exporters just is not available for small business in this country.

A study by Price Waterhouse estimates that U.S. exports would have been $5.3 billion lower in 1979 if the DISC incentive had not been in place. Looking at the probable direct corporate income taxes, personal income taxes and payroll that result from such sales, the Price Waterhouse document shows that DISC actually returns $1.24 to the Treasury for each dollar of tax incentive provided.

I have reviewed the Price Waterhouse analysis, giving particular consideration to the assumptions used there as they would be applicable to small business. I am not an economist. The assumptions appear valid. In particular, the existence of excess manufacturing capacity is a fact of life for most of us. We can with ease supply foreign customers without any disruption of our ability to serve domestic markets.

If Congress were to kill DISC now, in light of its positive contribution to the economy, we in small business might well feel that if Congress doesn't think foreign sales are important, we're not going to think they're very important, either.

[From The Wall Street Journal, Wednesday, July 15, 1981]

U.S. IS DRAFTING PLAN TO GIVE EXPORTERS BIGGER TAX CUTS, MEET GATT OBJECTIONS

(By Art Pine)

WASHINGTON.—The Reagan administration is drafting a plan that would give U.S. exporters $1 billion more in tax reductions than those provided under the Domestic International Sales Corporation program.

The plan is being designed to replace the existing DISC program, which has been declared unacceptable by the General Agreement on Tariffs and Trade, the Geneva-based organization that polices the international trading system.

U.S. representatives are scheduled to tell GATT officials in Geneva today that the Reagan administration won't object to final disposition of the matter as early as October. Previously, Washington had stalled action on the GATT complaint.

However, the White House isn't expected to unveil its plan formally—or even present it officially to high-level Cabinet councils—until Congress has completed work on Mr. Reagan's 3-year, 25 percent tax-cut proposal.

"We don't want to do anything to interfere with the tax bill," one high official said.

The White House has been under congressional pressure to replace the DISC law, which was enacted in 1971 as part of an export promotion plan by the Nixon administration. The program provides $1.8 billion a year in tax incentives by allowing exporters to set up a paper corporation whose earnings from foreign trade are effectively tax-exempt.

Former President Carter had tried to get the lawmakers to repeal the DISC law, saying that it wasn't any longer needed to spur exports and that it primarily benefited a few large companies. But heavy lobbying by business resulted in defeat of the Carter proposals.

The new proposal drafted by David Macdonald, deputy U.S. special trade representative, would eliminate the DISC program and replace it with a system of "world-wide export corporations" whose income technically would be taxed, but at a zero or near-zero rate.

Treasury estimates show the new plan would give exporters $2.8 billion in annual tax relief.

Sources described the Macdonald plan as similar in concept to a law—repealed in 1971—that lowered the tax rate on goods sold to buyers in Latin American countries.

The differences between the existing DISC program and the new plan are essentially structural. GATT found that the DISC law violated its regulations that barred exempting export income from taxation. The new plan theoretically would tax export income, but do so at zero rates.

Sources said the Macdonald plan has been discussed informally by U.S. Special Trade Representative William Brock and Treasury Secretary Donald Regan, but hasn't been taken up formally for fear of disrupting work on the omnibus tax-cut bill.

However, administration officials said the proposal has received generally favorable response in informal discussions with members of the Senate Finance and House Ways and Means Committees. Both panels have warned they won't act to repeal the DISC law unless a replacement plan is in sight.

The Carter administration conceded the DISC program's incompatibility with GATT rules in negotiations with the organization's officials in Geneva in 1979. But the Carter administration insisted the DISC case be linked with three minor complaints involving European countries in formal disposition of the issue.

The latest U.S. understanding with European officials is for the Reagan administration to agree to final disposition of the DISC case after October, with a companion promise that GATT won't penalize the U.S. for continuing the program until Congress has time to enact a substitute, probably by early 1983.

Analysis of the 1981 Treasury Report On DISC

WILLIAM H. GREEN

The 1981 Treasury Report on DISC operations reveals increased profits and tax-deferral for export activities of U.S. multinationals.[1] Information contained in the Report indicates the number of DISC elections has grown significantly in the past year. In addition, DISC sales for 1979 were almost $100 billion, which is almost two-thirds of total U.S. manufactured exports.[2] Net income for the period grew to nearly $6 billion, a 23 percent increase from the prior year, and 120 percent higher than the 1974 DISC year.[3]

This article examines the operational data contained in the Report. After a review of prior Reports, the data is analyzed for planning present and future DISC activities. Proposals for revising the DISC report and statute also are considered.

Background

The most recent Treasury Report was released in April 1981. The information is for the 1979 DISC year which is based on data in returns filed by companies

---

WILLIAM H. GREEN is a partner in the law firm of Robert Feinschreiber & Associates in New York City. Mr. Green is also the Associate Editor and a member of the Editorial Advisory Board of the *International Tax Journal*. He received his B.A. from Trinity College and his J.D. from Suffolk University Law School.

---

[1] *Operation and Effect of the Domestic International Sales Corporation Legislation—1979 Annual Report*, released by the Treasury Department, April 28, 1981 (Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402), hereinafter cited as the "1979 Annual Report."

[2] 1979 Annual Report, p.1.

[3] 1979 Annual Report, p. 26.

with a taxable year ending between July 1, 1978 and June 30, 1979. This Report is authorized by law and is the eighth annual report to Congress.[4]

The prior Reports have been examined in earlier issues.[5] In general, the information published in each Report has varied, so a comparison of such areas as DISC audit results and the geographic destination of DISC sales is not possible.

The current Report does contain some new information not reported in the earlier Reports. The 1981 Report analyzes four separate product lines or classes.[6] This data is useful for industry comparisons and establishes some standards for evaluating current DISC benefits.

For purposes of this analysis, the product class data is grouped into five categories:

Nonmanufactured Products
Basic Manufactured Products
High Technology Manufacturers
Resource Related Manufacturers
All Other Manufactured Products

The Report does not indicate whether the product classes are determined on the basis of SIC, trade or industry designation, SEC reporting, or some combination. The Report does show specific products in each major product class,[7] but it is not clear if this list is exclusive. Moreover, some secondary products are listed as specific products in the Report. Thus, aircraft and parts are included as high technology products while motor vehicles and other equipment are shown as basic manufactured products. The data for these products is included under transportation equipment in the Report.

Comparison of DISC Data

A five-year comparison of basic DISC data is shown in Table 1. Every category showed an increase in 1979 over the 1978 data.

The total number of returns filed in 1979 increased by 543. The prior Report showed a decrease in 1978. The number of returns filed, however, has not increased significantly since the 1975-1976 period.

Number of Elections and Returns Filed

Various factors affect the number of filings. The number of DISC elections always exceeds the number of returns filed (see Table 2). For example, many companies have more than one DISC, through acquisitions or due to

---

4. Sec. 506, Revenue Act of 1971 (P.L. 92-178).
5. *See* Green, "Planning DISC Operations in the '80's", 6 *Int'l. Tax J.* 373 (June 1980); Green, "Analysis of the 1977 DISC Report," 3 *Int'l. Tax J.* 597 (October 1977); Feinschreiber, "Analysis of the 1976 DISC Report," 2 *Int'l Tax J.* 301 (July 1976).
6. 1979 Annual Report, p. 10.
7. Table [illegible]

internal performance evaluations. Divisional managers and controllers are finding DISC deferral benefits reduce taxes and improve financial results. Separate DISCs also may be formed for transactions with boycotting countries, sales of military property, or other transactions which can taint otherwise qualified DISC activities.

Another factor affecting reporting DISCs is disqualification on audit. Companies can lose significant benefits on audit. Most DISC audit changes impact expense allocation and other pricing adjustments. These changes are minor or can be cured with a deficiency distribution.

Disqualification of receivables or producers' loans are less frequent, but involve larger dollar amounts. These audit issues should not be resolved without the advice of outside counsel and may take a long time to resolve. In this event, a new DISC should be formed at minimum cost. The new DISC can begin operating and deferring income taxes on sales prospectively. The tax benefits in the new DISC are not reduced by adverse audit results in the former DISC.

Gross Receipts and Income Data

Gross receipts on DISC sales grew $13.7 billion in 1979 to $99,603 billion, an increase of 16 percent. This increase is the largest dollar and percentage increase since prior to 1975.

The Report indicates three factors affecting DISC receipts:[8]

1. increase in worldwide and domestic inflation,
2. growth of overall world trade, and
3. devaluation of the dollar.

The Treasury has pointed out these factors in prior Reports,[9] but they do not explain why sales and income data would fluctuate since 1975. Even including these factors, the Report shows the 1979 DISC year was a good year for most U.S. companies.

Similarly, the increase in DISC income in dollar amounts and percentage is the highest since prior to 1975. This increase also is reflected in the 24 percent growth of DISC assets in 1979 (see Table 7).

The profitability on DISC sales (gross receipts/net income) in 1979 increased to 6.4 percent. This figure is slightly higher than the 6.1 percent in 1977 and 1978.

Revenue Cost—Past, Present and Future

The revenue cost of DISC rose from $730 million in 1978 to $994 million in 1979.[10] Most of this 36 percent increase can be attributed to the increase in DISC deferred income. The following table reflects the percentage of DISC deferred income from 1976-1978:

---

[8] 1979 Annual Report, pp. 8 and 9.

[9] *See* 1978 Annual Report, p. 2.

DISC Year	Percentage of Deferred Income
1976	49
1977	30
1978	29
1979	32

The first year the incremental rules were effective was 1976, which caused the substantial decrease in deferred earnings. After 1977, the base period years were fixed (1972-1975), so this data is unchanged until 1981. Thus, the annual growth in current period receipts reduced incremental rule distributions.

The 1982 Report should show a similar increase in DISC deferred income. Beginning in 1981, however, the base period years will roll forward (1973-1976) each year. Since many U.S. companies had relatively high exports in 1976 and 1977, this roll forward will decrease deferred income.

The reduction in deferred income will reduce the revenue cost of DISC, but this impact will not be reflected in DISC Reports until 1983 or 1984. This information is used often in formulating tax policies and must be available on a more current basis. The Treasury Report to Congress, therefore, should estimate the revenue cost of DISC based on current data.

Investing DISC Deferred Funds

Many U.S. companies are distributing up to 70 percent of their DISC earnings as a result of the incremental rules. If interest rates remain high, the value of the DISC tax deferral will increase. Thus, financial managers should monitor DISC operations to maintain qualification and optimize the return on DISC deferred funds. For example, PEFCO paper can yield between 11 and 13 percent, which seems low in today's interest market. The effective tax rate on the PEFCO interest, however, will be lower than other corporate interest receipts, so the effective yield is much higher.

More companies must seek creative financing techniques in order to maintain DISC eligibility. For example, loans can be made to unrelated U.S. manufacturers that can qualify as producers' loans. This technique avoids fugitive capital problems.[11]

Another example would be acquiring FCIA-insured receivables from unrelated parties. Since limitations on acquiring these assets have been eliminated in a recent Tax Court case,[12] using a banking or finance DISC for generating additional deferred income is now feasible.

---

[11] Sec. 995(d); Reg. Sec. 1.995-5.

[12] *Arrow Fastener Co., Inc., et al.*, 76 TC No. 34 (March 12, 1981).

The incremental rules should be revised to exclude DISC investment income from the adjusted taxable income (ATI) computation.[13] The congressional rationale in enacting the incremental provisions in 1976 was the necessity of tracing DISC benefits only to increases in a company's export sales.[14] The intent, therefore, was to interrelate incremental distributions and base period sales. This intent is evidenced by the export gross receipts ratio, which only includes active sales and service receipts of a DISC.[15]

The original intent of Congress in enacting the DISC legislation was to increase and finance export sales to create more jobs.[16] For this purpose, Eximbank, FCIA, PEFCO, and ECCO paper can qualify as a DISC asset, in addition to trade receivables and other internal financing devices.

In order to be consistent with the original objectives, the incremental rules should apply only to sales or service income of a DISC, not to passive income, such as receivables interest, interest on other financial obligations, or FISC dividends. In addition, passive income should be excluded from the determination of the small DISC exemption.[17]

These changes would permit U.S. multinationals to maximize the return on investment of DISC deferred funds used in financing exports. The current administration has reduced the role of government in financing foreign trade by reducing the Eximbank's commitments. The amendments proposed above would assist in generating a new commercial market for financing export trade.

DISC Operations

Much of the data on DISC operations in the recent Report is unchanged from prior years. The largest 48 DISCs, which constitute less than 1 percent of all returns filed, generate more than 50 percent of all DISC receipts and 42 percent of DISC income (see Table 4-B).[18] These operations are also the least profitable. The smallest companies have a profit margin nearly three times higher (18 percent) than the larger DISCs. This trend has been examined in earlier reports.

The most profitable companies have a majority corporate shareholder. Noncorporate majority shareholders do account for over 30 percent of the DISC returns filed but their profit margin is 4.0 percent, lower than the average 6.4 percent (see Table 3).[19]

---

[13] Sec. 995(e)(2).

[14] General Explanation of the Tax Reform Act of 1976 (H.R. 10612, 94th Congress, P.L. 94-455), prepared by the Staff of the Joint Committee on Taxation (December 29, 1976), p. 291.

[15] Sec. 995(e)(4).

[16] *See* Feinschreiber, *Tax Incentives for U.S. Exports* (Dobbs Ferry, N.Y.: Oceana Publications, Inc., 1975), p. 158.

[17] Sec. 995(f).

[18] 1979 Annual Report, Table 4-3, p. 22.

[19] 1979 Annual Report, Table 4-2, p. 21.

Small DISC Exemption

The Report indicates 45 percent of the returns filed, or over 3,200 companies, were eligible for the small DISC exemption (see Table 4-A).[20] This exemption applies to incremental distributions if the DISC income is less than $100,000.

The exemption is phased out if income is more than $100,000, but less than $150,000.[21] The Report does not indicate the number of companies eligible for the phase-out benefit.

The small DISC exemption is a safe-haven for some companies. The incremental rule may be so severe as to distribute almost all the current DISC income. In this event, the DISC sales can be reduced to generate $100,000 of income and qualify for a deferral of at least $50,000.

For small businesses, this $50,000 deferral is not an incentive to export, since additional administrative and accounting costs are incurred. The small DISC exemption, therefore, should permit these companies to exclude $100,000 from deemed dividend distributions, or give a credit to offset export sales income. This direct relief to small companies would be more favorable.

In addition, the exemption phase-out should be raised to $200,000. Based on Table 4-A, this increase would affect nearly one thousand additional companies and only increase revenue costs on 3 percent of the deferred income, or approximately $13.8 million.

Product Line Data

The data on products exported by DISCs has been divided into four categories.[22] The Report initiated segment reporting this year in order to estimate the impact of DISC on exports in each category. The four new categories are:

Nonmanufactured Products (Table 5-A)
High Technology Manufacturers (Table 5-B)
Basic Manufactured Products (Table 5-C)
Resource Related Manufacturers (Table 5-D)

Five separate product lines dominate export sales. Agricultural products, transportation equipment, nonelectrical machinery, chemicals and electrical machinery and equipment generate over $77 billion or 78 percent of DISC receipts. These products have been broken down for purposes of inclusion in the categories as discussed earlier in this article.

High technology manufacturers produce 33 percent of the DISC gross receipts and over 50 percent of the DISC income. (See Table 5-B.) The profitability of these operations was nearly 10 percent.

---

[20] 1979 Annual Report, Table 4-4, p. 23.

[21] Sec. 995(f)(2).

[22] 1979 Annual Report, p. 40.

Nonmanufactured products, which includes agricultural products, has the lowest profitability with 1.8 percent. (See Table 5-A.) This data is difficult to analyze since agricultural products may be sold and resold a number of times before leaving the United States. This category accounted for over 25 percent of DISC sales, yet earned only 7.5 percent of DISC income.

Basic manufactured products were the other major category of DISC sales (see Table 5-C). These products include motor vehicles, construction and mining machinery and engines and turbines.

Three product lines averaged over $2 million of tax deferred income per return: photographic equipment ($3.264 million), tobacco manufacturers ($2.600 million) and engines and turbines ($2.282 million). These product lines were from different product categories.

The five most profitable products were:

Product	Profit Margin (%)
Photographic equipment	14.7
Transmission and distribution equipment	12.3
Office machinery	11.7
Furniture and fixtures	11.7
Ordnance and accessories	11.6

All of these products are high technology products, except furniture and fixtures, which is a basic manufactured product.

DISC Pricing Methods

The data on DISC pricing methods is found in Table 6.[23] The information is reported on the basis of nonmanufactured and manufactured products. The prior portion of this article examined the quantitative comparisons in these product categories. This section will examine distinctions from the 1980 Report on the 1978 DISC year.

For nonmanufactured products, the total gross receipts increased only $500 million. More companies (46) filed returns using the 50-50 pricing method in 1979 than in the prior year. This increase is over 30 percent in the number of returns, but totals nearly $600 million. This increase is more than the total increase in sales of nonmanufactured products.

The profitability of nonmanufacturing companies using the 50-50 method was 7.9 percent. The Report indicates companies with a profit margin less than 8 percent are using the wrong pricing method, unless they are electing marginal pricing benefits. This method generally is advantageous where foreign sales are less profitable than domestic sales. Otherwise, a company with a profit margin of 7.5 percent should elect the 4 percent method ($4\% \times 100 = \underline{\underline{4}}$), rather than the 50-50 method ($50\% \times 7.5 = \underline{\underline{3.75}}$).

---

[23] 1979 Annual Report, Table 5-3, p. 29.

Nonmanufacturing companies using the 4 percent method are eligible for the exceptions to the no-loss rule if profit margins drop below 4 percent. One important exception, the customary profit margin exception, allows the DISC to earn up to 4 percent and shift a loss to the parent.

Less than 40 percent of the companies selling nonmanufactured products used the DISC safe-haven rules. These companies, however, accounted for over 75 percent of total receipts. These statistics were similar in 1978, except the overall profitability of these products increased from 1.6 to 1.8 percent.

Sales of manufactured products are more profitable (see Table 6). Over 90 percent of these exports were subject to the safe-haven pricing rules.

The pricing on sales of manufactured products followed more conventional patterns. Thus, the profit margin under the 50-50 method is over 10 percent and the profit under the 4 percent method is 3.7 percent.

Sales of manufactured products increased over 20 percent between 1978 and 1979. Most of this increase is reflected in sales under the safe-haven rules. The overall profitability, 8 percent, on sales of manufactured products was the same for both 1978 and 1979.

DISC Balance Sheet Data

As indicated earlier, total DISC deferred income grew $3.77 billion (see Table 7[24]). Most of these funds were invested in trade receivables. (see Table 8[25]).

Although the dollar amount of investments increased in each category of DISC assets, only four categories increased as a percentage of total assets: Eximbank obligations, export property, other qualified assets and nonqualified assets.

Eximbank obligations probably include PEFCO or ECCO paper. The Report is not clear, but this is not surprising since many returns are prepared with PEFCO paper listed on the balance sheet as Eximbank obligations. In fact, few qualified Eximbank or FCIA obligations are outstanding and held by DISCs.

Many companies also list PEFCO paper as other qualified assets. Thus, it is not clear if the increase in this category and Eximbank obligations is due to the same asset, PEFCO paper.

Nonqualified assets increased by ½ percentage point. This figure is within the 5 percent safe-haven for satisfying the assets test, but can be expected to increase in the future as qualified assets become more difficult to acquire.

---

[24] 1979 Annual Report, Table 5-1, p. 27.

[25] 1979 Annual Report, Table 5-4, p. 31.

DISC Audits

The Report does not produce audit data as provided in earlier Reports. Some information, however, is given for the 1980 calendar year.

Audit adjustments in 1980 reduced DISC income by $312.7 million. Thus, an additional $70 million in taxes (50% x $312.7 million x 46%) was paid by DISC shareholders.

The 1980 audit adjustments were attributable to the 1974-1977 tax years. Over 70 percent of the adjustments were for intercompany pricing charges. The other major audit problem was the failure to meet the assets test.

Conclusion

The Eighth Annual Report on DISC provides useful data in evaluating the results of DISC operations and pricing methods. The data should contain an analysis of past results and future projections of DISC activities so Congress and Treasury officials can evaluate the DISC program more effectively.

Table 1. Comparison of Basic Data
(1975-1979 DISC Years)

	1975	1976	1977	1978	1979
Total No. of Returns	5,498	6,431	6,911	6,665	7,208
Gross Receipts ($ Mil.)	66,277	73,220	82,681	85,887	99,603
Receipts/Return ($ Mil.)	12.05	11.39	11.96	12.89	13.82
Net Income ($ Mil.)	4,781	4,764	5,062	5,211	6,402
Profit Margin (%)	7.2	6.5	6.1	6.1	6.4

Table 2. DISC Elections

Year Ending	No. of New Elections Filed	% of Total	Total No. of Elections	% Increase
1972	3,439	25.3	3,439	--
1973	1,386	10.0	4.825	40.3
1974	1,913	13.8	6,738	39.7
1975	1,520	11.0	8,258	22.6
1976	1,073	7.7	9,331	13.0
1977	693	5.0	10,024	7.4
1978	756	5.4	10,780	7.0
1979	1,144	8.3	11,924	10.6
1980	1,565	11.3	13,489	13.1
1981 (Jan. and Feb.)	307	2.2	13,796	
Total	13,796	100.0		

Table 3. Profitability of DISC Shareholders

Asset Size of Majority Corporate Shareholders	Number of Returns	Gross Receipts ($ Mil.)	Net Income ($ Mil.)	Profit Margin (%)	Tax-Deferred Income per Return ($)
1+	64	53	2.7	5.1	17.2
100,000+	635	636	38.0	6.0	26.8
1,000,000+	1,495	2,364	169.6	7.2	47.0
5,000,000+	606	2,286	118.2	5.2	80.4
10,000,000+	1,100	14,877	544.5	3.7	179.1
50,000,000+	269	3,577	245.4	6.9	513.0
100,000,000+	291	5,207	429.4	8.3	469.1
250,000,000+	185	8,764	503.0	5.7	890.8
500,000,000+	122	9,421	668.6	7.1	1,679.5
1,000,000,000+	211	43,439	3,321.8	7.7	4,768.2
Subtotal	4,978	90,623	6,041.5		387.8
Other shareholders	2,230	8,921	360.5	4.0	63.1
Total	7,208	99,604	6,402.1*		287.4

---

* As per Table 4-2, 1981 DISC Report.

Table 4-A. DISC Operations Based on Net Income Comparison

Income Subject to Deferral	Returns		Gross Receipts		Net Income		Tax Deferred Income			Profit Margin Percentage
	Number	% of Total	Amount ($ Mil.)	% of Total	Amount ($ Mil.)	% of Total	Amount ($ Mil.)	% of Net Income	per Return ($ Thous.)	
$1+	3,241	45.0	3,162	3.2	120.2	1.9	57.3	47.7	17.7	3.8
$100,000+	972	13.5	2,456	2.5	139.3	2.2	59.4	42.6	61.1	5.7
$200,000+	1,383	19.2	12,313	12.4	641.1	10.0	224.2	35.0	162.1	5.2
$1,000,000+	576	8.0	19,194	19.3	1,254.9	19.6	407.2	32.4	706.9	6.5
$5,000,000+	96	1.3	8,366	8.4	682.9	10.7	217.8	31.9	2,268.8	8.2
$10,000,000+	54	0.7	13,718	13.8	826.8	12.9	265.3	32.1	4,913.0	6.0
$25,000,000+	20	0.3	8,551	8.6	672.2	10.5	206.6	30.7	10,330.0	7.9
$50,000,000+	16	0.2	30,316	30.4	2,091.6	32.7	633.5	30.3	39,593.8	6.9
Other DISCs	850	11.8	1,529	1.6	(26.9)	(0.4)	–	–	–	(1.7)
All Returns	7,208	100.0	99,604	100.0	6,402.1	100.0	2,071.3	32.3	287.4	6.4

Table 4-B. Profitability of DISC Operations Based on Gross Receipts

Gross Receipts	Number of Returns	% of Total	Gross Receipts ($ Mil.)	% of Total	Net Income ($ Mil.)	% of Total	Profit Margin (%)
1+	376	5.2	9	*	1.7	*	18.9
50,000+	866	12.0	126	0.1	13.0	0.2	10.3
250,000+	1,700	23.6	983	1.0	98.0	1.5	10.0
1,000,000+	2,740	38.0	9,400	9.4	726.2	11.3	7.7
10,00,000+	844	11.7	24,619	24.7	1,805.7	28.2	7.3
100,000,000+	90	1.2	14,459	14.5	1,016.1	15.9	7.0
250,000,000+	48	0.7	50,007	50.2	2,715.4	42.4	5.4
Inactive DISCs	544	7.5	--	--	25.9	0.4	--
Total	7,208	100.0	99,604	100.0	6,402.1	100.0	6.4

---

*Less than 0.1 percent

Table 5-A. Profitability of DISC Sales by Product Categories

Nonmanufactured Products	Number of Returns	Gross Receipts ($ Mil.)	Net Income ($ Mil.)	Profit Margin (%)	Tax Deferred Income ($ Mil.)	Tax Deferred Income per Return ($ Thous.)
Grain Products	100	22,516	278.9	1.2	97.3	973.0
Other Agri. Prods.	199	2,100	62.7	3.0	22.1	111.0
Mineral Products	114	333	10.7	3.2	3.7	32.5
Other Nonmanufactured Products	521	1,089	126.6	11.6	47.5	91.1
Total	934	26,038	478.9	1.8	170.6	182.6

Table 5-B. Profitability of DISC Sales by Product Categories

High Technology Manufacturers	Number of Returns	Gross Receipts ($ Mil.)	Net Income ($ Mil.)	Profit Margin (%)	Tax Deferred Income ($ Mil.)	Tax Deferred Income per Return ($ Thous.)
Ordnance and accessories	46	247	28.7	11.6	6.3	136.9
Inorganic, organic chemicals	78	4,339	476.1	10.9	152.0	1,948.7
Plastics materials, etc. including fibers	81	2,019	181.5	8.9	60.7	749.3
Agricultural chemicals	74	1,262	51.6	4.0	13.1	177.0
Other chemicals and allied products	274	1,871	201.0	10.7	62.6	228.4
Transmission and distribution equipment	27	1,023	125.8	12.3	38.4	1,422.2
Electronic components, etc.	407	3,482	309.6	8.8	109.9	270.0
Other electrical machinery and equipment	572	4,380	366.0	8.3	130.6	228.3
Photographic equipment	25	1,718	253.4	14.7	81.6	3,264.0
Other professional & scientific instruments	346	2,133	207.5	9.7	75.4	217.9
Special industry machinery	363	1,890	166.0	8.7	56.2	154.8
Office machinery	72	1,989	233.6	11.7	83.2	1,155.5
Aircraft and parts	164	7,396	657.4	8.8	174.5	1,064.0
Total	2,529	33,749	3,258.2	9.6	1,044.5	413.0

Table 5-C. Profitability of DISC Sales by Product Categories

Basic Manufactured Products	Number of Returns	Gross Receipts ($ Mil.)	Net Income ($ Mil.)	Profit Margin (%)	Tax Deferred Income ($ Mil.)	Tax Deferred Income per Return ($ Thous.)
Textile mill products	243	991	57.4	5.7	18.4	75.7
Apparel, etc.	137	245	11.0	4.4	4.5	32.8
Furniture & fixtures	39	28	3.3	11.7	1.5	38.4
Printing, publishing, etc.	84	285	29.2	10.2	9.9	117.8
Rubber, misc. plastic products	141	640	41.9	6.5	13.8	97.8
Leather & leather products	110	1,358	13.4	0.9	5.1	46.3
Stone, clay, glass & concrete products	71	665	62.7	9.5	21.7	305.6
Fabricated metal products	605	2,774	223.9	8.0	78.9	130.4
Engines & turbines	34	3,062	260.3	8.5	77.6	2,282.3
Construction, mining machinery	183	5,116	392.8	7.6	124.3	679.2
Other machinery, except electrical	573	3,631	274.4	7.5	83.0	144.8
Motor vehicles and equipment	221	11,102	671.0	6.0	107.3	938.0
Other transportation equipment	56	218	17.0	7.8	5.1	91.0
Total	2,497	30,115	2,058.3	6.8	651.1	260.7

Table 5-D. Profitability of DISC Sales by Product Categories

Resource Related Manufacturers	Number of Returns	Gross Receipts ($ Mil.)	Net Income ($ Mil.)	Profit Margin (%)	Tax Deferred Income ($ Mil.)	Tax Deferred Income per Return ($ Thous.)
Food and kindred products	270	2,592	183.9	7.0	65.1	241.1
Tobacco manufacturers	10	715	71.0	9.9	26.0	2,600.0
Lumber, etc., except furniture	190	1,947	71.5	3.6	22.5	118.4
Paper & allied products	162	1,525	102.3	6.7	25.2	155.5
Primary metal industries	175	1,366	76.4	5.5	22.6	129.1
Total	807	8,145	505.1	6.2	161.4	200.0
All Other Manufacturers	441	1,556	101.6	7.5	43.9	99.5

Table 5-E. Summary of DISC Sales by Product Categories

Product Category	Gross Receipts ($ Mil.)	% of Total	Net Income ($ Mil.)	% of Total	Profit Margin (%)
Nonmanufactured Products	26,038	26.1	478.9	7.5	1.8
High Technology Manufacturers	33,749	33.9	3,258.23	50.8	9.6
Basic Manufactured Products	30,115	30.2	2,058.3	32.1	6.8
Resource Related Manufacturers	8,145	8.2	505.1	7.8	6.2
All Other Manufacturers	1,556	1.6	101.6	1.8	7.5
Total	99,603	100.0	6,402.1	100.0	6.4

Table 6. DISC Pricing Methods

NONMANUFACTURED PRODUCTS

Pricing Method	Number of Returns	% of Total	Receipts ($ Mil.)	Net Income ($ Mil.)	Profit Margin (%)
50-50 Method	193	20.7	1,270	101.4	7.9
4% Method	163	17.5	18,502	259.9	1.4
Arm's-Length	182	19.5	1,069	32.8	3.0
50-50 and 4%	30	3.2	2,008	46.1	2.3
Not Determinable	366	39.1	3,188	41.9	1.3
Total	934	100.0	26,037	482.1	1.8

MANUFACTURED PRODUCTS

Pricing Method	Number of Returns	% of Total	Receipts ($ Mil.)	Net Income ($ Mil.)	Profit Margin (%)
50-50 Method	2,681	42.7	33,276	3,387.7	10.1
4% Method	1,398	22.3	14,215	527.2	3.7
Arm's-Length	809	12.9	3,665	286.9	7.8
50-50 and 4%	356	5.7	19,080	1,520.6	7.9
Not Determinable	1,030	16.4	3,329	200.8	6.0
Total	6,274	100.0	73,565	5,923.2	8.0

Table 7. Comparison of DISC Assets ($ Mil.)

DISC Year	DISC Assets	$ Increase	% Increase
1974	5,873	--	--
1975	9,406	3,533	60
1976	11,832	2,426	26
1977	14,678	2,846	24
1978	15,955	1,277	9
1979	19,725	3,770	24

Table 8. DISC Balance Sheet Data
($ Millions)

DISC Assets	1977	% of Total	1978	% of Total	1979	% of Total
Working Capital	422	2.9	432	2.7	460	2.3
Eximbank Obligations	849	5.8	925	5.8	1,200	6.1
Trade Receivables	8,840	60.2	10,162	63.7	12,416	63.0
Export Property	912	6.2	713	4.5	901	4.6
Producer's Loans	2,137	14.6	2,568	16.1	3,031	15.3
Other Qualified Assets	1,481	10.0	1,136	7.1	1,616	8.2
Nonqualified Assets	37	0.3	19	0.1	101	0.5
Total	14,678	100.0	15,955	100.0	19,725	100.0

Mr. NOWAK. We will now hear from Jack Rennie.

TESTIMONY OF JOHN C. RENNIE, PRESIDENT, PACER SYSTEMS, INC., BURLINGTON, MAINE, AND VICE PRESIDENT, SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND (SBANE)

Mr. RENNIE. Thank you very much, Mr. Chairman.

I will summarize my comments and perhaps add a few details that may flesh out the picture a little bit as far as my own company, and so forth.

As you mentioned, I am the president of Pacer Systems, and we manufacture aviation equipment. In 1977, we were a $3 million a year sales company, and currently we are at $10 million. In 1977, we had zero exports, and now we have about $1½ million a year. Our total sales are climbing at a 30-percent rate overall; our export sales are actually climbing faster, and they are going from probably the 15-percent level, where they are now, to probably near a 20-percent level as we look out over the next couple of years.

We have 260 people in the company that is headquartered outside Boston. But we also have plants in Pennsylvania, and Virginia, and California as well. Thirty-five of our people are directly involved with manufacturing exports. All of our exports to now have been manufactured goods.

Recently we have been actively considering forming a DISC, although I am not sure I want to do that now; but we will see what develops.

I am also vice president of the Smaller Business Association of New England, or SBANE, as it is called. This association has 2,000 companies through all industries, so it is not a trade association per se. So, when we are addressing things like international trade, we are addressing it across a wide variety of industries. We have an international trade committee that has a very active program, both formal programs—that is different type of specific meetings, et cetera—and we have developed over the last 3 years extensive networking, in effect, so that we have become a one-stop shop for our members. Frankly, many people call us who are not our members. They have sometimes very specific questions, such as with a new type of customs form or some such thing, or much more major strategic questions. We can always now point them to a knowledgeable person or get them the answer immediately ourselves.

The MASSPORT program that Tom Rees mentioned was actually initiated at SBANE. We were the ones who then convinced MASSPORT to collaborate with us and really do most of the work, because they had the budget that we didn't have. That collaboration continues and it is extremely successful. As a matter of fact, I was on the first MASSPORT-SBANE trip in November 1977, which really was the thing that got me convinced of the potential of export for my own company.

Tom mentioned all of the kinds of walkthrough. The other most important element to me was they identified all of the people around, like Tom and others, who can help you when you do this. This is one of the main problems that a small business manager has when he is considering exporting, or when we are trying to get him to consider exporting, that he sees his own staff and his own time quite taken up already, and he anticipates a fantastically increased load. By pointing out all of the people, international bankers, export management companies, and so forth, that are around to help you is perhaps one of the most important elements of the whole program to me.

A year ago, as I mentioned in the formal testimony, we conducted a survey, a quite extensive survey, within SBANE, and there were quite a few interesting points that emerged from this. As a very gross reading, we had 8 percent of our members who were involved in exporting, which I think from the number I recall through the White House Conference and since is about typical for the country. Yet, it was amazing to see the wide variety of things that people were exporting, everything from high-tech equipment down to bird cages. It was really unbelievable. The last numbers we had had was that in aggregate, SBANE companies were putting out something like $30 million a year in exports and, in fact, it was $100 million and had grown radically over the intervening 5 years or so since they had last looked at it.

Of those companies, it broke down into two specific areas. There were companies whose export sales were below $200,000, and that group averaged $60,000, and 10 percent of that group had DISC's. Then there was a very definite higher group that had sales above $200,000, averaging about $1½ million, and 35 percent of those companies had DISC's.

The focus of our efforts in SBANE has been to try to focus on the new-to-export company, which basically is a company not now exporting and we are trying to entice them to consider it, or someone who is new in doing some of it and we are trying to get them to do more of it. So we generally have not been dealing with mature exporting companies.

The basic premise that we start from and really are our thoughts about the subject today is that, essentially, the country needs more exports and it needs small business to participate more in that export field. These goals are in the best interest of the country. In other words, one shouldn't look at incentives as a giveaway or something like that, but rather that it is merely a mechanism for promoting what is really in the country's best interest. That is very important because it goes to the heart of this business that there is absolutely no reason why industry and Government should be at antagonistic points. It is essentially trying to come up with the best solution to do the best for everybody concerned.

The potential, as has been alluded to here earlier, is enormous, I think, if you can tap it. If we could get 3,000 companies in the country to do just what my company has done, it would add $4 billion or $5 billion a year to our exports. At what I think is kind of an accepted rate of around 20,000 jobs per $1 billion of exports, it multiplies out very quickly into some meaningful job statistics.

Our research into this whole thing and our activities with our members and others have indicated very much a DISC-plus situation, to borrow a phrase that was just mentioned a little while ago. There are three major areas, all of which have to be working in order to really address the small business participation in exports. The first is incentives; the second is what I would call in the general sense education, which is what the MASSPORT program, for example, did, or at least started to do for me. The last is to facilitate the flow of marketing information.

Today we are talking mostly about incentives, so let me just hit the others quickly. Education is in the sense of overcoming a lot of myths and perceived difficulties that the companies can encounter when trying to get into the foreign markets. In previous testimony about barriers to trade, and normally they are looking for what barriers does France have, for example, to prevent small companies from coming into France. Usually, the testimony ends up centering more about the barriers of getting out of the country rather than the barriers of getting into the foreign country. That is more of a big company issue, because if it is difficult getting into a particular country, then the small company will just go somewhere else. They don't have to go to France, they will just go somewhere else if it is too difficult to deal. The other important element of education is to identify the sources of help and how you can overcome some of this. There is a considerable amount of help available, but you just have to point these out to people and do it in some sort of logical way.

There are things going on to improve the market information. I think the improvement in the foreign commercial service that is underway certainly will help in that regard. Even things like the export trading companies, and so forth, are also things that might help the marketing end of it. But everything starts with incentives. As Tom mentioned, basically small American companies are built on a domestic premise, a domestic market premise. Very few start up saying, "We're going to really build our whole company around selling to Great Britain," for example. As a result, whenever a small company manager is wrestling with the problem of getting into exports, it is really a decision of relative opportunities. Should I start exporting to Western Europe or should I expand my business to the Southwest or in the Northeast? It is seldom that they have saturated the domestic market for their product. So this puts the small business in the United States in quite a different position than, say, a similar business in West Germany or Great Britain. There they can much more quickly saturate their market, and they go outside their country to gain market, and that is the source of their growth. Frankly, I think that is basically why most of our significant exporters are very large, because they reach a stabilized market share domestically, and they go outside because it is the thing to do for growth and expansion.

Unfortunately, though, the record has shown that most domestic small companies have been opting to expand domestically and not get into the exporting, and that is what we are trying to get here. We have to get them started. The first question they ask is, "Why should I bother?" We address it by what we call hard and soft incentives. The soft incentives are the sorts of things you might say are qualitative and they are very meaningful, like countercyclic hedges, extension of product life, things of that nature.

Then you get to what we call hard incentives. They are really bottom-line kinds of things such as better profitability, in many cases, with overseas sales. Our surveys, for example, show that, on average across all of our exporters, their export sales were more profitable than their domestic sales. Then you come to tax deferrals or hard incentives, and here is a place where the Government is uniquely capable, although I certainly subscribe to the idea that the Small Business Administration and Commerce are great sources of information. We in the private sector can help that process very much. But when it comes to incentives, it is kind of a uniquely Government-oriented factor.

Although I don't think there are any of us that would argue that DISC isn't flawed and it does have difficulties and it is complex here and there, probably mostly because when the law was put through and amended, like most laws, until very recently, the small business input wasn't there, the impact on small business wasn't considered. But at least it shows the Government interest. It can contribute to some degree, as Leo has indicated previously, although it does need improvement. A good alternative would probably end up being better. You could shape it especially now where the small business impact would be much more drawn into the whole debate and evolution of whatever the replacement would be. Certainly we would like to have a part in that. We would very much like to make suggestions.

But we do feel very strongly that whatever alternative should be in place first, before we take the DISC out. I think it would send the wrong message to everyone concerned. It would create a lot of confusion. I think, on balance, it would be counter to the United States interests. So that is pretty much of a summary of what I feel, Mr. Chairman.

Mr. NOWAK. Thank you very much, Jack, for taking the time to come here. I think the main purpose of this hearing is to try to get ahead of the problem and have this ready to present to the tax writing committee. Instead of having them look at just one or two alternatives, such as doing away with the DISC or simply amending the DISC, I think there are other things that we should be looking at, especially after sitting here and reviewing some of the previous testimony.

[Mr. Rennie's prepared statement follows:]

PREPARED STATEMENT OF JOHN C. RENNIE, PRESIDENT, PACER SYSTEMS, INC., BURLINGTON, MAINE, AND VICE PRESIDENT, SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND (SBANE)

First, I would like to thank you for the opportunity of appearing before you today. This is a subject of great interest and concern in the smaller business sector, and your efforts to highlight it as an issue before Congress is very much appreciated by those of us actively involved in promoting increased exporting by small businesses.

My name is Jack Rennie, and I am president of a fast-growing, high technology company, PACER Systems, Inc. PACER manufactures flight simulation equipment and airspeed measuring systems for helicopters. We also provide a broad range of advanced systems design, development and support services, usually in complex, aircraft-related applications. The company's 1982 sales will be about $10 million, over 15 percent of which will be from foreign customers. Since 1977 when our total sales were about $3 million with no exports, foreign markets have become an important element in the overall company plans and strategies. It appears that our export sales will continue to grow in absolute terms and probably stabilize in the 15 percent to 20 percent area of total sales.

I am also representing here today the Smaller Business Association of New England (SBANE). This is a regional association of almost 2,000 companies from the 6-State region and from virtually all industrial sectors. SBANE has a very active International Trade Committee of which I am a member and past chairman. This committee has developed what probably is the most comprehensive private sector program for promoting small business exporting in the country. About a year ago, we completed a detailed survey of the SBANE membership regarding their involvement in international trade. The results of that survey and the many inputs the committee has received from individual members over the past 5 years form the backdrop of my comments here today.

I am sure that I need not recount for the members of this subcommittee all of the sad tales of the United States' performance in international trade in recent years. But it is worth emphasizing that our decline in net exports of manufactured goods—$7 billion in 1981 and actually showing a deficit of more than $4 billion in the first half of 1982—has been a significant contributor to the current recession. This decline can be equated to a loss of at least 250,000 jobs. Now there are a number of contributing factors to this picture * * * decreased productivity and quality, high interest rates and so on. But I would submit to you that if the U.S. exporting base of companies were broader and included more small companies, our performance would be much improved. As we have seen from our surveys, and the work of industry researchers, small companies are the most innovative and productive sector of our economy, and show every indication that if we can get this sector to "think export," we can dramatically improve the country's balance of trade.

It is important to set this background because it is vital that we all understand that it is important to the future of the country that more small businesses participate in exporting. This means that when we ask the Congress or the administration to help promote small business exports we are not asking with some altruistic or self-centered motivation. We are asking because it is in the country's best interest as a whole to make more use of this underutilized potential.

And what is this potential? Small companies (fewer than 500 employees) contribute only about 8 percent of exported manufactured goods, yet produce over 20 percent of all the goods manufactured in the United States.

According to Department of Commerce figures, of the 300,000 manufacturing companies in the U.S., only about 25,000 export at all, and something like 85 percent of all manufactured exports are produced by only 250 companies. If we use the figure developed by other studies that there are at least another 30,000 companies with export potential, we can begin to grasp the dimensions of the picture * * *. Suppose we could get just one in ten of these non-participators to do what my company has done over the past few years; the 3,000 new exporters, averaging 1.5 million in foreign sales would generate $4.5 billion in new exports per year * * * a figure that could grow greatly with time. (I should parenthetically mention that the service sector shows every indication of at least as much potential as the manufacturing.)

At SBANE, as I have indicated, we have done considerable researching into the elements of this problem and have solidly concluded that the three essential ingredients to increasing small business' contribution to the export picture are: incentive; education, and improving the flow of marketing information.

Since we are focusing attention on incentives today, allow me to quickly allude to the others first. By "education" we mean that small business managers' fears of complexities, pitfalls and excessive demands on their time can be greatly allayed by dialog with knowledgeable and sensitive businessmen and others involved in international trade. It was my participation in the joint SBANE-Massachusetts Port Authority Small Business Export Program that did this for me, and put me on the track to our export sales.

"Improving the flow of marketing data" alludes to an impediment most small businesses have in reaching overseas markets and gaining timely access and understanding of foreign buyers' requirements. The revitalization of the Foreign Commercial Service now underway and the Export Trading Companies legislation now under consideration show the growing awareness of this facet of export promotion.

But, the process all starts with incentive. Before you can get the small business owner or manager "educated" or get him or her searching out marketing information, he or she must perform some mental tradeoffs regarding where the company's assets should be placed. In short, the business manager does not consider exporting as an independent effort which will succeed or fail on its own merit. Rather, he or she looks at it as one of several opportunities or uses of the company's limited resources. The underlying dynamic is different than large companies because most small businesses are built around a domestic market premise (i.e. potential sales in the U.S.) and few, if any, have saturated this entire market. Thus, the issue often boils down to: "Should I expand to western Europe, or the southern U.S. States; should I pursue customers in South America, or open an office or plant in Seattle."

Needless to say, when a manager encounters these decisions, lacks familiarity with the overseas situation and has preconceived notions of risk and complexity, the decision usually favors domestic expansion. Big companies, on the other hand, usually have developed a more or less stabilized domestic market share; so their primary incentive to export is growth in sales and profits by selling to a bigger total market.

When discussing incentives for exporting to managers of small companies, we tend to divide them into what we call "soft" and "hard" categories: "Soft" incentives include such qualitative factors as: broadened customer base; counter-cyclic hedges against U.S. economic variations; improved company image; extended product life cycles; and even opportunities to travel; "Hard" incentives are more quantitative in nature and essentially aim at improving profitability or capital formation or retention. These are currently limited to DISC and the fact (borne out in our survey) that, on average, export sales are more profitable than domestic.

In some areas, such as Massachusetts, additional incentives of this sort exist. In Massachusetts, for instance, the tax law provides for a direct reduction of corporate income tax for a company's export sales in accordance with a formula.

The reason why export incentives are such a germaine issue to be discussing here today is that they are the one area uniquely within the control of Government. We in the private sector can supplement Government's role in education and fostering the flow of marketing data, but we can't directly address tax incentives and the like.

It is for this reason that we fought hard before the White House Conference on Small Business and since to preserve DISC and improve its applicability to small business. We have taken that tack because DISC is currently the only meaningful incentive offered to entice companies into international trade. Naturally, we are very interested in considering other options for incentives; but we would caution against cancellation of DISC before these other options are in place.

I have recently completed three years as a member of the Industry Sector Advisory Committee-Aerospace (ISAC-1) under the Secretary of Commerce and the U.S. Trade Representative. In fact, I was the only small business member of that committee. During my ISAC-1 term, I became aware of the pressures being brought to bear by other countries to eliminate DISC as an "unfair" subsidy of exports and not in the spirit of the Tokyo Round of the GATT Agreements.

I would submit to you, in this regard, that these arguments are weak and almost ludicrous in light of the blatant, direct subsidizing of exports going on in several major signatory nations. Furthermore, the point needs to be made that legitimate incentives for exporting are essential to the interests of the United States because of the relatively large domestic market here compared to other countries and the need for broad U.S. industry participation in trade to achieve some balance with other nations to whom our domestic market provides a juicy target for their exports. In short, if you are a smaller company in Germany, you are more likely to have saturated your domestic market and you have plenty of incentive to go elsewhere; the reverse is not true here.

For these reasons, Mr. Chairman, I urge retention of DISC and modification of it to be more useful to smaller firms, as recommended by the White House Conference. Alternatively, if other incentives can be formulated, we would be supportive and would be happy to join in their development. But DISC should not be eliminated before one or more alternatives are in existence and operating.

I hope this has been helpful to the committee; and I again thank you for the chance to convey our thoughts on this. I would be happy to answer any questions you may have.

Mr. **NOWAK**. Let me call on Alexander now, who has a contributed to our hearings before and was very helpful with our LIFO hearings. I think we have made some progress in that area and, hopefully, we can do the same here.

TESTIMONY OF ALEXANDER ZAKUPOWSKY, JR., PARTNER, DELOITTE, HASKINS & SELLS

Mr. **ZAKUPOWSKY**. Thank you, Mr. Chairman.

I ask that my entire statement be put in the record, and I will summarize my views as others have done.

The issue I would like to address is why the DISC provisions do not sufficiently motivate small business to enter export markets. At the outset, I would like to say that, although I have a lot of bad things to say about DISC, it does work to a significant degree and is an effective export incentive.

The DISC provisions provide a partial deferral of tax on income from exporting. This requires first that there be taxable income. We find that many small businesses that expand in the foreign markets actually don't have taxable income and, therefore, DISC would be of no benefit.

Further, one of the most significant barriers facing a small business in going into an export market is the high initial cost of entering that market, finding out where the market is and how to exploit that market. DISC is a long-term proposition. It is one that gives deferral on tax dollars that are earned over a period of time. It does not compensate for these initial costs up front.

There are two primary reasons why a small businessman will not factor in the long-term potential of DISC into his equation in determining whether or not he will be sufficiently compensated for the initial market entry costs. One is the lack of understanding of DISC, and the other is its restrictions.

We have heard a lot today about the complications of DISC. I would like to add that we usually see clients smile when you say you can form a DISC and the DISC need not pay any tax. That is the good news of the good news/bad news scenario. We then, however, point out the complications of DISC which are incorporated in 7 code sections and some 100 pages of regulation. Yes, I actually sat down and counted the pages.

If the businessman isn't scared off and is willing to undertake the challenge or obtain professional help, it is found that, in order to initially qualify for DISC, you must meet certain requirements. Right away he is confronted with such terms as qualified export receipts and qualified export assets, terms with meanings far beyond those in the common usage of the words.

Most small businessmen form what is called a commission DISC. This is probably the simplest arrangement. I want to stress simplest. I am speaking of the simplest arrangement for using a DISC today. There are other options which present even more complexity. A commission DISC does not take title to the property, but merely earns a commission as a sales agent on the property sold. Now I must say that some of our clients with DISC's might have to think twice if you were to ask them if they had a DISC. The DISC is really only a paper corporation. It does not interfere with the general operations of how the man goes overseas and exploits the market.

Although there are some potential problems in the formation of a DISC and there are professional fees that must be incurred in putting it together—the $50 fee I heard this afternoon was the lowest I have heard, but there are fees involved—the complexity involved really pales in comparison to the operation of a DISC. As a preference to a discussion of the complexity of maintaining a DISC, it should be noted that most DISC's, especially commission DISC's, have no operations in the sense of employees or assets, as I have mentioned. They operate as shells and are paid a commission.

These guidelines are particularly difficult to understand for small businessmen because of their lack of substance. You give an individual a group of rules and you put no economic reality behind them, and soon they are forgotten. This often, as the gentleman to my left has pointed out, ends up with an unintended disqualification of the DISC.

Turning to the operation of a DISC, a DISC is permitted to realize taxable income in an amount which does not exceed the greater of one of three methods of determining taxable income allowed under the law. These methods are very complex and are included in the regulations. Obviously, some of the benefits of the DISC are associated with the optimal use of one of these three methods. Such a choice is to the benefit of the taxpayer. However, the taxpayer must go through the three computations to determine which is the best. He does three times the amount of work for one tax saving.

In applying these rules, cost accounting techniques must be applied to determine the cost of goods sold, selling expenses and export promotion expenses. Many small businesses must add to the sophistication of the cost accounting systems to meet these requirements.

Even after the small businessman, his accountant or his attorney understands the rules and the records are kept, the burden continues in monitoring compliance on an annual basis. You have heard mention of the 95 percent or more qualified gross export asset test and that of the qualified export receipt test. Because the critical determination of qualified export assets is made at yearend, the taxpayer must project the level of qualified export assets before yearend and, if necessary, make adjustments in asset holdings which present their own complications. Similar monitoring and adjusting may be required to meet the qualified gross receipts test.

Another source of complexity is the incremental provision added by the DISC rules in 1976. When these were introduced, Congress had in mind an exemption for small business by exempting DISC's with income of $100,000 or less from the rule. We find that the limit is completely too low, and small businesses find themselves approaching that very rapidly and then have to make all sorts of business decisions on whether or not those incremental sales above the $100,000 are appropriate and are financially beneficial.

As already noted, a DISC is generally a nonsubstantive corporation with regard to operations. However, it imposes some real restrictions on the business operations of the group to which the DISC belongs. This is a subject which I haven't heard much of today. It is not uncommon for a business to be off target in satisfying its export receipts or export asset requirements. If this is detected and there is sufficient time to make a correction, there is a turn from the normal business operations to that of correcting the defect. There is a tremendous cost in having that defect. Therefore, the businessman finds himself, instead of worrying about how to export a new product or going into a new country, worrying about how to get hold of a qualifying export asset. Such investments may not be ideal investments because of their rate of return or the term to maturity, and obviously restrict the resources which the business has to put elsewhere. What small businessman has excess cash to make such investments? This problem is particularly acute at times when there is a downturn in the economy and normal export assets, such as for example receivables, do not support the export asset requirement and cash reserves are at their shortest.

As another example, the business may be faced with pursuing foreign sales to meet the export receipt requirement, even though domestic sales are more profitable at the time.

Another example of the DISC restrictions which are dictated to business is found when the DISC's parent is forced to borrow funds to pay the commission earned by the DISC in order to preserve DISC benefits. I want to stress this one because it is a very typical situation.

A commission receivable on a DISC's books is an export asset only if it is paid within 60 days. While receivables may not be collected in this time from the foreign customer, the IRS requires that the cash flow from the parent to the DISC to actually satisfy this obligation. If the DISC's parent is short on working capital, as many small businesses find themselves, it is common to have to go to the bank, borrow the money, pay an interest cost, pay the commission, and then recycle the funds back to the parent so the bank loan can be satisfied. There is no true economic purpose. However, it does affect the corporation's ability to use working capital or borrow funds for other sources.

I would like to make one final point on DISC, and that is the uncertainty of its future. For years in counseling clients, we have been asked if DISC will be here next year or a few years in the future. In all honesty, we must professionally say that we don't know. I have seen any number of small businessmen turn away from DISC because they cannot count on its benefits as being lasting.

I think that whatever Congress decides to do to increase exports, it ought to be done on a long-term basis, it ought to be allowed to settle in, and its opponents ought to be told to look elsewhere.

Thank you for the opportunity to present these views, Mr. Chairman.

[Mr. Zakupowsky's prepared statement follows:]

PREPARED STATEMENT OF ALEXANDER ZAKUPOWSKY, JR., PARTNER, DELOITTE, HASKINS & SELLS

My name is Alexander Zakupowsky, Jr. and I am a partner in the international public accounting firm of Deloitte Haskins & Sells. We welcome this opportunity to present our views on the utilization of the Domestic International Sales Corporation (DISC) provisions by small businesses.

There are many barriers to a small business contemplating expansion into export markets. One of the largest is the initial cost of finding and developing the foreign markets. DISC provides a partial deferral of taxes on income from export sales but does little in the short term to compensate for high market entry costs. In fact, many businesses incur losses for a period of time after entering a new market. Tax deferral during this stage is of no value. The benefit of DISC must be viewed over the longer term. Many businesses have benefited from DISC over the longer term and these benefits have contributed to their ability to expand foreign sales, but few, if any, have found DISC the impetus to initially enter foreign markets.

The decision to expand into a new market is based on the assessment of risk and potential for profit. Generally, businessmen view the risks of overseas expansion as higher than domestic expansion. Consequently, they look for higher profits. Although DISC provisions can provide a significant tax benefit which can translate into higher profits, small businessmen generally do not factor this potential benefit into their decision to export. The principal reasons for this are the lack of knowledge about DISC and the inability to apply its rules in a way that will allow a small businessman to quantify its potential benefits. Generally, it is only after the threshold is crossed and a DISC is formed that the small businessman gets to experience the benefits of DISC. In many cases this results in an enthusiasm to expand foreign markets or the ability to become more price competitive.

However, even many small firms that export do not avail themselves of the DISC provisions. Not factoring DISC benefits into export decisions or using DISC for export sales is primarily caused by (1) the lack of understanding DISC and (2) its restrictions.

LACK OF UNDERSTANDING

To put it simply, DISC is complicated, even for the Internal Revenue Code. Upon reviewing the DISC rules a taxpayer is presented with a "good news, bad news" scenario. The good news is that the general rules governing the taxation of corporations do not apply to a DISC—a DISC is generally exempt from Federal income tax although it must pay state income tax. However, the bad news is soon found—a DISC has its own rules encompassed in seven sections of the Code. These rules are supplemented by over 100 pages of regulations.

If the businessman is not scared off and is willing to undertake the challenge or obtain professional help, it is found that in order to initially qualify as a DISC certain requirements must be satisfied. These requirements use such terms as "qualified export receipts" and "qualified export assets"—terms with meaning for a DISC beyond the common usage of the included words.

(1) A separate domestic corporation must be set up. To most this means employing a lawyer, at a fee of at least several hundred dollars.

(2) The new corporation must have separate books and records, usually involving fees for an accountant.

(3) The new corporation must have its own bank account; and

(4) Only one class of stock (although this requirement seems simple enough it can prove to be one of the many traps for the unwary when the IRS argues that loans are in substance a second class of stock);

(5) The corporation must also have capital of at least $2500; and

(6) Must elect to be a DISC.

Two further requirements must be satisfied after the initial formation of a DISC:

(1) 95 percent or more of the corporation's gross receipts must consist of "qualified export receipts," and

(2) 95 percent or more of its assets must be "qualified export assets."

Most small businesses form what is called a "commission DISC." These DISC's do not take title to the property sold but "earn" a commission as a sales agent. A compensation or commission agreement (at additional cost) must be drawn up between the parent and DISC.

The complexity involved in setting up a DISC pales in comparison to its ongoing operation. As a preface to a discussion on the complexity of maintaining a DISC it should be noted that most DISC's, especially those formed by small businesses, have no operations in the sense of employees or assets used in the active operation of a business. They operate as shells and are paid a commission for export sales under statutory guidelines. These guidelines are particularly difficult to understand because of their lack of substance. This lack of substance over time can also lead to a less than conscientious administration of the DISC and often an unintended disqualification of the DISC.

Turning to the operation of a DISC, a DISC is permitted to realize taxable income in an amount which does not exceed the greater of:

(1) 4 percent of qualified export receipts attributable to the sale of export property plus 10 percent of related export promotion expenses;

(2) 50 percent of the combined taxable income of the DISC and its related supplier attributable to qualified export receipts plus 10 percent of related export promotion expenses, or

(3) taxable income based on an arm's-length pricing of the goods.

Obviously some of the benefits of a DISC are associated with the optimal use of these three methods. Such a choice is to the benefit of the taxpayer, but it requires alternative computations to select the most advantageous method. In applying these transfer pricing rules cost accounting techniques must be applied to determine cost of goods sold, selling expenses and export promotion expenses. Additional complexity is added by the regulations which require computations to be made on a transaction-by-transaction basis or, under a special rule for grouping transactions, on a product line basis. Many small businesses must add to the sophistication of their cost accounting systems to meet these requirements.

Even after the rules are understood and the records are kept the burden continues in monitoring compliance with the asset and receipt rules. Because the critical determination of qualified export assets is made at year-end the taxpayer must project the level of qualified export assets before year end and, if necessary, make adjustments in asset holdings, often by investing in certain export related securities. This presents its own complication, that is, the evaluation of the available securities that may be less than an ideal investment because of their rate of return or term to maturity. Similar monitoring and adjusting may be required to meet the qualified gross receipts test.

Another source of complexity is the incremental provision added to the DISC rules in 1976. Under this provision DISC benefits are limited to income attributable to export gross receipts in excess of 67 percent of the average export receipts during a 4-year base period. Although DISC's with incomes of $100,000 or less are exempted from this rule, receipts must be monitored and considered in determining the incremental benefits of DISC.

DISC RESTRICTIONS

As already noted, a DISC is generally a non-substantive corporation with regard to operations. However, it imposes some real restrictions on the business operations of the group to which DISC belongs.

It is not uncommon for a business to be off target in satisfying its export receipts or export asset requirements. If this is detected with sufficient time to make corrections, resources of the business may be turned away from normal operations to cure the defect. Under our comments on complexity we discussed the investment in export related securities to meet the qualified export asset requirement. Such investments obviously restrict the resources of a business and cause the loss of other opportunities. This problem is particularly acute at times when there is a downturn in the economy and normal export assets, for example, receivables, do not support the export asset requirement. As another example, a business may be faced with the choice of pursuing domestic sales or foreign sales and select foreign sales to meet the export receipt requirement, even though the same resources could have produced greater domestic sales and larger profits.

Another example of DISC restrictions dictating business behavior is found when the DISC's parent is forced to borrow funds to pay the commission earned by the DISC in order to preserve DISC benefits. A commission receivable on the DISC's books is an export asset only if paid within 60 days. The IRS requires that cash must flow to the DISC's bank account to satisfy this requirement. Small businesses must often extend credit to foreign purchasers for over 60 days to compete with foreign sellers. If the DISC's parent is short on working capital, as many small businesses find themselves, it is common to borrow the money, at an interest cost, pay the commission and recycle the funds back to the parent so the bank loan can be satisfied.

FUTURE OF DISC

One final point is the uncertainty of DISC's continuation. It is a provision that has been under attack for several years by adversaries in our country as well as by our trading partners. This atmosphere has made some small businesses reluctant to depend on it for any lasting benefits. Other small businesses that have formed DISC's fear its repeal and the adverse consequence that would follow if the deferred taxes had to be paid. This atmosphere only adds to the uncertainty of making a decision to export or expand exporting.

In summary, DISC can be a meaningful tax benefit to businesses that use it. However, generally it is not a motivating factor in the decision of a small business to export because its benefits are long-term and do not compensate for the initial high costs of market entry in the short-term.

Furthermore, DISC is too complex and restrictive. It does not allow small businesses to properly understand its benefits and consequences or utilize it without significant cost.

Finally, the uncertainty involved in DISC's continued existence only adds to the risk associated with dealing in foreign markets.

Thank you for the opportunity to present these views.

Mr. **Nowak**. Thank you very much.

I think all of this testimony, although it hit on different aspects, combines to make a very thorough record and gives us the opportunity to look at an overall view of the DISC as it is now working and see where it can be made more meaningful. If we do modify it, we might as well modify it to make it better all around rather than just take a piece of it and change it to satisfy what I consider a very artificial reason, and that is to make it GATT-legal. That seems to be where the bigger emphasis is coming from rather than the economic analysis of what it is actually doing or not doing.

Hopefully, we will take this opportunity to review with members of Ways and Means Committee the whole picture of the DISC rather than the narrow view that has been presented, the fear that this is somehow going to upset our trading partners unless we disavow it and completely set it aside and write it out of the tax law.

There is no question that some incentives—you can call them incentives or subsidies—are going to be necessary. We are looking at incentives through the Tax Code now rather than an overt Federal program which would subsidize an investment in an exporting company or in a product line. If we don't want to go in that direction for budgetary reasons, then using the Tax Code is the only alternative left.

Unfortunately there are other pressures that are pulling against the use of DISC and our whole system has been, I think, unbalanced to some degree. When you are talking about our domestic economy, this is a great new kind of way to smooth out the unbalances and, hopefully, work out of this recession a lot quicker. If we can overcome the GATT situation and, at the same time, have a modified DISC, thus doing something that makes some sense and yet which will satisfy the State Department and the International Trade Department and all the others.

This may be difficult to bring together because they really are looking at different pressures from different areas. I think that in the testimony all day today some of it pointed specifically to that GATT problem, and others pointed to the very basic problems of setting up DISC's and what has been contributed, by the ones that have been set up, and what we are missing in new employment, new job creation, and certainly new productivity.

One of the things that struck me as I have been reviewing this material over the last 3 or 4 days is having a system of distribution of this information when we do modify it. This could be done through a meeting of an existing group in an area, or a statewide initiative, or having some type of general information and guidance set up at the Federal level to be distributed to the State level where it could be reachable by corporate structures within the State.

Some means could be derived to get this information very quickly into the small- and medium-size business arena. It could be a great help. Perhaps this whole review and modification of DISC will end up with a totally better program.

We certainly want to thank each of you for coming and taking the time on behalf of your different organizations.

Charles Bruce was also supposed to testify, but I understand he became ill. We will keep the record open for his testimony to be sent in.

[Mr. Bruce's prepared statement with attachment follows:]

PREPARED STATEMENT OF CHARLES M. BRUCE, ATTORNEY, COLE & CORETTE

My name is Charles Bruce. I am a member of the firm of Cole & Corette. This statement is submitted on behalf of Cole & Corette and does not necessarily represent the views of any other person or group.

We have recently completed a study of foreign tax practices and how they affect foreign exporters, that is, those foreign businesses that compete with U.S. exporters.

A summary of the study can be found at pages 5 through 7 of the document, a copy of which is attached. The detailed information as to each of the six countries examined follows that summary (pages 8 through 52).

We understand that the study in its entirety will be included in the printed record.

It should be noted that the information on each country's tax practices was supplied and the writeups reviewed by correspondent counsel in each of the subject countries. In some instances, more than one correspondent counsel in a country was used.

The study was underwritten by the Dow Chemical Company, which does not necessarily concur with the views expressed therein.

Several additional points may be of interest to the subcommittee.

First, while it is true that some foreign countries exempt foreign earnings of a foreign branch, as well as those of a foreign subsidiary, it is more common for foreign exporters to utilize foreign sales subsidiaries located in favorable tax jurisdictions. Should the United States decide to rewrite its rules applicable to exporters, in order to make them more clearly compatible with our international trade obligations, we believe that rules permitting the use of foreign sales corporations (sometimes referred to as foreign international sales corporations, of FISC's) should be viewed as comporting with international standards.

Second, it is our belief that medium-size and even small foreign exporters successfully utilize foreign sales subsidiaries. The incorporation formalities are frequently no greater than those encountered by U.S. persons when they organize, for example, a Delaware subsidiary. The requirements for an actual presence in the foreign country of incorporation are often minimal. Whether relatively small U.S. exporters could likewise utilize foreign sales corporations such as those envisioned by the Frenzel and Boren bills (H.R. 5179 and S. 2708, respectively) may well depend on the presence requirements imposed, which again are minimal under the Boren bill and only slightly greater under the Frenzel bill. Perhaps some special rules should be contemplated for smaller exporters.

Lastly, it has been said that the Frenzel bill and the Boren bill adversely affect small exporters under certain circumstances. The point made—which we believe has some merit—is that any provisions which set an arbitrary level for a dividends received deduction, so as to implement the tax benefit, will be based on the assumption that the present incremental rule would apply but for the existence of the proposed change. Yet, small exporters are presently exempted from the workings of the incremental rule. I would only add that since the Boren bill does not repeal DISC, small exporters cannot be worse off under the Boren approach, and given that the Frenzel bill provides a 100 percent exemption for earnings of the International Sales Corporation, it is unlikely that a small exporter would be worse off under the Frenzel approach. Still, the point is well taken, we think, and legislators interested in a partial exemption utilizing an approach similar to that of these two bills may want to provide an analogue to the present small exporter exemption from the incremental rule.

We appreciate having been given this opportunity to submit our study and views for the record.

FOREIGN TAX PRACTICES AFFECTING EXPORTS

July 1982

COLE & CORETTE

FOREIGN TAX PRACTICES AFFECTING EXPORTS*/

Introduction

This report presents information as to how exporters in six foreign countries are taxed. The six countries are France, Germany, Japan, the Netherlands, Sweden, and the United Kingdom. These countries were selected because they are important competitors of the United States, and their laws exemplify various foreign tax rules applicable to exports.

The purpose of this report is to present a realistic picture of how a typical manufacturer in each country is taxed on its export sales, taking into account existing statutory, treaty and case law provisions, administrative practices of foreign tax and currency control authorities, and responses of foreign exporters and their advisors to this landscape. It represents an attempt not to rely so much upon descriptions of statutory provisions and rates as to discuss what practices are actually being pursued. This approach springs from the thought that if one were to analyze the effective rate applied to exports through a DISC, one would be relying upon actual tax return data, not statutory rates adjusted for perceived effects of various tax law provisions. In the absence of tax return data for foreign exporters, however, an attempt to describe actual practices may be at least as informative as a description of statutory provisions.

This report was developed by first compiling information on the foreign statutory, treaty and case law provisions, then engaging correspondent counsel to complete and update this material and, importantly, to comment on how they are advising exporters in the country in question to structure their transactions so as properly to minimize tax liabilities. (A copy of the standard request for information telexed to correspondent counsel is attached hereto.) It should be noted that sometimes foreign exporters will structure their transactions for purposes other than tax, such as for reasons of business flexibility. Also, while compliance is a problem in some countries, illegal or what were judged to be overly aggressive tax plans were not taken into account.

---

*/ This study was prepared at the request of The Dow Chemical Company. One or more correspondent counsel were consulted in each of the six subject countries. The views expressed, however, represent those of Cole & Corette and do not necessarily represent those of any other person or group.

Prior studies have addressed the issue of foreign country tax practices applicable to exports. For example, in 1975 Hufbauer examined the taxation of export profits by various industrialized countries by focusing on the costs of capital engaged in export production.*/ He also compared the tax costs of capital for export sales versus domestic sales. Of sixteen countries studied, the U.S. burdened capital employed in export sales more heavily than any other country, with the possible exception of Germany. (If special rules applicable to "development areas," such as West Berlin and border zones, were taken into account, German burdens would fall below U.S. levels; approximately 10% of the Federal Republic of Germany falls within such a development area.) Perhaps more importantly, for the group of sixteen countries the mean differential between burdens on export sales and burdens on domestic sales was 24 points, whereas for the United States this differential amounted to only 15 points. These facts indicate that other countries typically foster exports over domestic production to a greater degree than does the United States. This paper was based on statutory rates and provisions. Certain arbitrary assumptions, of necessity, were incorporated.

Also, in July of 1975, a comprehensive study entitled "Comparison With Practices of Foreign Countries" was appended to testimony presented to the Senate Budget Committee.**/ This study described, among other things, the tax and non-tax export incentives of six foreign countries: Belgium, France, Germany, the Netherlands, Japan, and the United Kingdom. It will be noted that this study predates certain significant changes in foreign law, such as the corporate tax law changes in Germany, and that it was not the intention of its authors to depict the practices followed by foreign exporters so much as to outline the various statutory rules.

In 1977, the National Planning Association published a report on "Income Taxation and Competitiveness in the United States, West Germany, France, the United Kingdom, and Japan" by Horst. The following table summarizes the study's findings:

---

*/ Hufbauer, Taxation of Export Profits, 28 NAT'L TAX J. 43 (1975).

**/ Task Force on Tax Policy and Tax Expenditures of the Senate Comm. on the Budget, "DISC: An Evaluation of the Costs and Benefits," 94th Cong., 1st Sess., p. 114 (Comm. Print 1975) (Appendix C, Testimony of Special Committee for U.S. Exports [July 23, 1975]). This study was updated by its authors and made current as of January 15, 1976.

TABLE: Summary of Estimates of Effective Rates of Taxation on Domestic, Export and Foreign Investment Income for Corporations Domiciled in the United States, West Germany, France, the United Kingdom and Japan

	Effective Rate of Taxation on:	
Country	Domestic Income*/	Export Income*/
United States	36.7%	27.4%
West Germany	39.7%	39.7%
France	34.3%	8.7%
United Kingdom	17.8%	12.2%
Japan	29.2%	17.9%

Notes:
*/Except in the case of the U.S., the rate assumes that a corporation pays a grossed up dividend equal to its retained earnings. A higher dividend payout rate would result in a lower effective tax rate

The author pointed out, however, that the above table was necessarily simplified, and that it focused only on income taxes. Other direct taxes, such as individual income taxes and social security taxes, consumption taxes, and more direct subsidies are not taken into account.

The National Planning Association published a second significant report in January 1982, called "Taxes, Subsidies and Competitiveness Internationally" by Mutti. This study analyzes the competitive effects of aggregate tax burdens and subsidies in six foreign countries (Canada, France, Germany, Italy, Japan and the United Kingdom) and the United States. In summary, the study found as follows:

> At the aggregate level, U.S. tax burdens, as measured in terms of shares of gross domestic product, are moderate compared to the other countries studied. Only in Japan do taxes account for a smaller share of Gross Domestic Product. However, allowing for government expenditures that assist or subsidize production gives a different picture of the net effect of government fiscal intervention on international competitiveness. By subtracting the benefits afforded by various subsidized expenditure programs, net tax burden figures are derived which suggest that the result of government fiscal intervention is to confront U.S. producers with relatively higher costs of labor and capital. Other things equal, this tends to discourage investment, employment and production in the United States.

As with the Horst study, the Mutti study was based upon statutory rates and provisions. In order to develop aggregate figures, a number of somewhat arbitrary assumptions had to be made. Also, no comparison was made with the income tax revenue pick-up anticipated under these analyses versus the revenue pick-up actually achieved. In fact, such a comparison probably could not be made because of the diversity of revenue reporting methods. Likewise, a comparison of anticipated effective rates with actual taxes paid by companies would be unreliable due to the differences in accounting methods; and it is a well-recognized fact that in most countries the publicly-held and nationalized companies are much less aggressive in their tax planning than closely-held, private companies.

The effects of "consumption type" value added taxes that "zero rate" exports and are applied on the destination-country principle are not debated in this study. In the U.S., it is often said that such taxes act to promote exports. Europeans point out, however, that while the U.S. does not have a federal level value added tax, the states have sales taxes that are not imposed on exports. In response, it is pointed out that sales taxes do not comprise as great a percentage of the total burden on exports as do value added taxes. And so the debate goes.

SUMMARY

The tax practices of six foreign countries have been examined to determine how they affect exporters in each country. Only the tax rules were reviewed. No attempt was made to examine non-tax programs such as export insurance and export financing programs.

It is generally believed if all forms of subsidization were analyzed -- non-tax as well as tax -- it would be found that, overall, other countries subsidize their exports to a greater degree than the U.S. Looking at tax rules alone, however, it might be assumed, based on descriptions of statutory provisions and rates, that certain other countries do not foster export performance to a remarkable degree. In fact, this is not the case. When actual foreign practices are drawn into the light, it is evident that every country, in one fashion or another, encourages exports by means of the structure and application of its tax laws. Each of the countries examined encourages exports in this way to a greater degree than the U.S. Also, with respect to each, a close examination of actual practices leads to the conclusion that taxation of exports is generally at an even lower rate than heretofore supposed.

Countries foster exports with tax laws and practices in widely varying ways. As a general rule, the number of overt "subsidies" in domestic tax rules has been reduced in recent years, but a number still remain. It is more common for favorable provisions to appear as foreign tax provisions in a country's internal tax laws. The territorial tax systems used by the Netherlands and France are obvious examples. Omissions in the coverage-tightening provisions of subpart F-type laws in the case of Japan and Germany are less obvious examples. One frequently encountered aspect is an approach to pricing rules that permits an allocation out of a large percentage of export profits. Based on the most recent developments, it would be an overstatement to say that foreign countries are moving in the direction of a more stringent enforcement of arm's-length pricing rules. In 1979, the OECD Council adopted a recommendation on the determination of transfer prices between associate enterprises. To date only one country, Italy, has enacted new provisions or finally promulgated new rules tightening enforcement in this area. Another aspect which is often overlooked is the treatment of export expenses. There are, in fact, two principal variables in intercompany pricing rules: supplier markup and supplier cost. It is obvious that if a markup of 8% over supplier's cost is required as a result of statutory provisions, regulations, or audit practices, less foreign source income will be available for low-tax treatment than if a 4% markup were allowed. Less obvious but more important is the effect of allowing a low figure for the supplier's cost -- usually by permitting the supplier to avoid allocating overhead cost to exports as an expense. No country examined appears to be actively pursuing this point.

As stated previously, each of the subject countries has its own unique approach to taxing exports. In each country, moreover, exporters are able properly to reduce their tax liability. While U.S. companies similarly are able to increase their DISC benefits or mitigate the effects of subpart F, it is apparent that foreign exporters can benefit from tax planning to an even greater degree.

- Under the French territorial system, income of a foreign branch is generally not subject to French taxation. Alternatively, where foreign subsidiaries are used, a two-tiered dividend system permits the retention of untaxed foreign source profits while allowing the distribution of tax credit-bearing domestic profits to French shareholders.
- There are a number of tax-free reserves that can be taken by a German parent with respect to its foreign subsidiary in harmony with a two-tiered dividend system similar to the French system, permitting the retention of untaxed foreign source profits while allowing the distribution of tax credit-bearing domestic profits to German shareholders.
- A Japanese corporation, by making use of a combination of certain domestic reserves, tax treaty rules and foreign law can, by using a Singapore trading subsidiary, avoid any tax on both the subsidiary's income and on dividends paid to the parent, as well as obtain a domestic deduction for developing an overseas market.
- In the Netherlands, the profits of foreign branches are generally exempt from Dutch taxes either by treaty or unilateral measures, while net losses of such branches often are deductible domestically. Where subsidiaries are used, income of a foreign subsidiary is not subject to Dutch tax nor are dividends received or capital gains arising from the foreign subsidiary generally subject to Dutch taxes. Also, offshore operations in the Netherlands Antilles, which are a part of the Kingdom of the Netherlands, are encouraged.

- In Sweden, in addition to certain tax-free reserves for development of export markets and export credit allowances, there are a substantial number of favorable tax treaties under which Sweden has agreed to forego taxation of income of a branch of a Swedish corporation located in another state but will still allow the deduction domestically of the branch's losses.

- A United Kingdom corporation can generally accumulate profits outside of the U.K. indefinitely. Using certain treaty countries, a U.K. corporation can receive domestic tax credits for taxes that it will not pay, because of a foreign tax holiday, under the "tax sparing" provision of the treaty.

FRANCE

I. Domestic Taxation

French companies are liable for tax on net profits from operations in France at a rate of 50%, with a minimum tax of 3,000 FF. Current overall deficits may be carried forward for five years. As a rule, subsidiaries of French companies are treated for purposes of taxation as separate entities and not consolidated. Under certain conditions, however, a parent and subsidiary may elect to consolidate their returns for purposes of the company tax. For such an election to be available, there must be prior approval from the Minister, both the parent and the subsidiary must be French, and the parent must own, either directly or indirectly, 95% of the subsidiary. Companies are considered French residents on the basis of their registered seat of business (unless this is fictitious -- in which case residence is where central control and management lie).

In computing taxable profit, French companies are permitted a variety of adjustments in addition to normal deductions for business expenses. Companies are allowed depreciation in accordance with the general practice in a particular industry. Both straight-line and declining balance methods are acceptable. Accelerated depreciation is permitted under certain circumstances. Capital gains are short-term on assets held for less than two years. While taxed at ordinary rates, short-term capital gains are included in income over a three year period, one-third in each year. Half of the amount invested for the creation or expansion of industrial, hotel, and fishing businesses in the Overseas Departments, for example, Martinique and Guadeloupe, is currently allowed as a deduction.

Other noteworthy features of French domestic taxation include investment incentives for new or expanding companies. In 1982 and 1983, small enterprises are exempt from tax on one-half of all profits, whether retained or distributed. Also, there are special-purpose reserves which are excluded from taxable profits unless and until they are no longer required for the specified purposes or are withdrawn or otherwise liquidated. The following reserves are available: reserve for bad debts; reserve for depreciation of raw materials and investments and against other risks and liabilities of business; reserves for maintenance of essential stocks and raw materials, or to cover price fluctuations of raw materials imported for processing; and reserves for research and exploration by mining and extractive industries operating in France or in the French Union (the latter includes African states which were previously French colonies). Newly formed corporations and those increasing their capital between January 1, 1977, and December 31, 1982, may deduct dividends paid in the following seven years from taxable income, up to 7 1/2% of cash subscriptions made during that period.

French goods and services are subject to a VAT of 17.6%, although luxury goods (including automobiles) are subject to VAT at a rate of 33 1/3%.

In general, if a French company owns 10% or more of another company, distributions received from such a company are exempt from taxation to the distributee. In practice, 95% of the distribution is exempt, with the tax law assuming that the other 5% is attributable to the distributee's management expenses with respect to the distribution. If the distributee can show that actual expenses with respect to the distribution are less, the exemption can be increased. It appears that distributees do take advantage of this provision, and it is estimated that generally 3% of such dividends are actually treated as non-exempt. The minimum holding of 10% may be disregarded where the interest is held in connection with an officially approved scheme benefitting the economy, or where the participation interest is in loan associations set up to finance investment in certain sectors of the economy.

Distributees of dividends always receive a tax credit (*avoir fiscal*) equal to 50% of the net dividends received. Distributees report as income the grossed-up dividend. If the profits from which the distribution is made have been subject to full company tax, there is no withholding by the distributing company. With respect to profits that are exempt, such as foreign source profits, a prepayment tax (*precompte mobilier*) equal to the tax credit amount is levied at the time of distribution.

A variation of the above is applied with respect to resident individuals except that any unused portion of the tax credit is refundable or creditable against his other tax liability. If the individual's marginal tax rate is 33 1/3% or less, he will pay no net tax on the dividend.

Finally, if the distribution is based on profits exempt from company tax, the distributing company must withold the prepayment tax from the distribution at a rate of 33 1/3%. However, the prepayment tax is not paid where the distribution is with respect to dividends received from a French subsidiary. This is because the French subsidiary's profits, having been fully taxed, carry with them the usual tax credit upon distribution to the parent. This credit covers the prepayment tax due on subsequent distribution by the parent. In contrast, exempt dividends received from foreign subsidiaries do not carry with them the tax credit, and thus the prepayment tax will be due on distribution by the French parent of dividends based on foreign subsidiary distributions.

Nonresidents are liable for French taxes on profits arising from operations in France. Any French profits earned by a nonresident company are deemed fully distributed and liable to a prepayment tax of 25% in addition to the company tax of 50%. If the shareholders are otherwise liable for French taxes, the 25% prepayment tax is available to them as a credit against their French tax liability. The prepayment tax is non-refundable to nonresidents, but may be refundable under double taxation agreements.

II. Foreign Taxation

A. Export Incentives

There are several different provisions in French tax law directed specifically at encouraging exports.

1. Option to be Taxed on Foreign Source Income

Companies with foreign source income may elect to include such income in calculating their overall French tax liability. This election must receive prior approval of the Minister of Finance. There are two alternatives available to a company which desires to make this election. Under the first alternative, the benefice mondial, the French company may combine its domestic income and its foreign income from direct operations abroad, such as foreign branches or income from a complete commercial cycle outside of France. Under the second alternative, the benefice consolide, the French company may include indirect income from operations which are under the control of the French company. This latter alternative allows consolidation of the operations of a foreign-based subsidiary of a French company with the parent's domestic operations and foreign branch operations. The French parent must own at least 50% of the voting rights in the subsidiary to be considered in control.

The election is made through negotiations with the Ministry of Finance for an agreed-upon period, usually five years, and is irrevocable for that period. It appears that these two alternatives were specially designed for French companies with important foreign interests, and particularly those engaged in overseas oil and gas exploration.

It appears that this election has not been frequently sought or allowed; as of 1976, approximately twenty companies had been permitted to elect the benefice mondial, while approval for the benefice consolide had almost never been given.*/ The advantage of this election is to permit losses from overseas operations to be offset against French domestic profits. An additional advantage is that dividends distributed out of foreign profits are not subject to the prepayment tax.

If either of these elections is made, the French company is allowed a tax credit for taxes paid to foreign governments by the foreign operation. This credit is limited to the amount of French tax that would have been due on the foreign income if taxed under French rules. The amount of any excess tax paid is allowed either as a deduction in the following year or as a credit over a five-year period. Otherwise, income and deductions based on foreign operations is generally computed according to the rules applicable to domestic operations.

2. Accelerated Depreciation

Accelerated depreciation is available on assets belonging to exporting enterprises.

3. Export Credit Risk Reserve

A company may set up a tax-free reserve to cover special risks arising from medium-term credits granted with respect to sales effected or work performed abroad. The amount that may be reserved is 15% of taxable profits or 2% of the relevant credits outstanding, whichever is greater. The total amount of the reserve is limited to no more than 5% of the total amount of medium-term credits outstanding.

4. Commercial Export Activities Reserve

If a French company establishes an overseas sales office, research, study, or information center, either through a foreign branch office or a 10%-owned entity (such as a foreign subsidiary), it may create a tax-free reserve. The amount of this reserve differs, depending on whether the investment is in an EEC country or elsewhere. In an EEC country, the reserve is limited to the lower of either (a) losses connected with such activities incurred during the first five years of operation or (b) the capital invested in the foreign branch or other entity. In non-EEC countries, the reserve is limited to an amount equal to the capital invested in the activities during the first five years of operations. Countries considered tax havens are excluded for purposes of this reserve. To set up this reserve requires prior authorization from the Minister of Finance, and this authorization is denied if the activities do not lead to an increased export of goods manufactured in France. Authorization is deemed to be given, however, if not refused within two months. The reserve must be restored to taxable income over a five year period beginning in the sixth year following the investment.

---

*/ Staff of House Comm. on Int'l Relations, 95th Cong., 2d Sess., Export Stimulation Programs in the Major Industrial Countries 124-125 (Comm. Print 1978).

5. Industrial Investment Overseas Reserve

French companies may establish a tax-free reserve with respect to industrial investments, such as manufacturing or processing, in certain foreign countries listed by the Minister of Finance. This list is comprised of developing countries. The amount of the reserve is limited to one-half the capital invested in the first five years of operation. The investment may be made through either a foreign branch of the French company or a 10%-owned subsidiary. As with the reserve for commercial export activities, the company must receive authorization from the Minister of Finance, and the reserve must be returned to taxable income over a five-year period beginning in the sixth year after the investment.

6. Value Added Tax

Goods and services destined for export are exempt from VAT, and may be purchased in France VAT-free or subject to a refund of VAT. The exemption is effected by means of an offset against other VAT liabilities in the case of small exporters and by means of a refund in the case of larger exporters. Refunds typically lag three months behind the export, but advance payment can be achieved by exporters that can show a regular quota of refunds.

7. Joint Export Programs

When small or medium size businesses create joint ventures to improve business, they can negotiate a tax agreement with the Minister of Finance which allows them both tax and nontax advantages. These provisions are made explicitly applicable to joint export programs. The following tax advantages are currently available: (a) the shareholders' investment in the stock of the new company may be fully deductible in the year made; (b) the company may depreciate its assets as usual; and (c) capital gains on the sale of shares in the company may be reinvested without taxation within one year in shares of a similar joint venture. However, the company is not eligible to deduct its expenses for the establishment of a foreign office.

B. Taxation of Foreign Income

The French tax system is based on the concept of territoriality. As a general rule, income generated by foreign operations is not subject to French tax. Foreign source income is defined as income that is either (1) related to a permanent establishment situated outside France; or (2) derived from operations abroad of dependent agents; or (3) derived from operations which constitute a complete commercial cycle (cycle commercial complet) outside of France. While there is no statutory definition of a cycle commercial complet, and taxpayers must rely upon case law, it is fair to say that something far short of manufacturing abroad will suffice to bring the activity within the rule; in fact, the concept commonly applies to purchase and resale activities. In practice, this means that profits generated by exports sold through a foreign branch or foreign subsidiary are commonly excluded from French taxation. In conformity with the principle of territoriality, losses and expenses arising from foreign operations are generally excluded as deductions from the taxable profits of a French company.

1. Unless a French company elects to be taxed on its worldwide or consolidated income, the principle of territoriality precludes French tax on the income of foreign branches or subsidiaries. There is no requirement that the foreign source income be subject to taxation in the source country.

2. Dividends received by a French company from a foreign company are exempt from company tax if the French company holds a 10% or greater interest. If the dividend exemption does not apply, the dividend is taxable net of foreign income and withholding taxes imposed.

3. As noted, foreign source income from either a branch or subsidiary of a French company is not subject to French company tax. If this income is subsequently distributed to shareholders the company must pay the prepayment tax. This may be avoided, however, if the French company does not distribute the foreign source income. French companies can designate the source of the profits from which a dividend is paid. Thus, if a French company earns half its profits from its own domestic operations which are fully taxed, or from dividends distributed by a domestic

manufacturing subsidiary, and earns the other half of its profits from foreign operations, such as a foreign sales branch or subsidiary, it can distribute dividends from the fully-taxed half of the profits and retain the other half tax-free indefinitely. It appears, generally, that French companies distribute half their current profits to shareholders.

4. Intercompany Pricing Rules -- Article 57 of the Code General des Impots

Related companies are required to use arm's-length pricing in intercompany transactions. Article 57 of the French Code General des Impots (C.G.I.) permits tax authorities to reallocate income and deductions where an abnormal advantage in prices has been granted by one company to a related company. The concept of related companies is not well defined, but includes companies sharing mutual interests whether by reason of legal ties or on the basis of fact. The 1982 Finance Act shifted the burden to the taxpayer as to whether two companies are related, by presuming that they are related if an abnormal advantage is found. The taxpayer may rebut this presumption. The tax authorities, however, still carry the burden of proving the existence of the abnormal advantage. The methods for computing arm's-length prices -- and thus, abnormal advantage -- are not well defined. Instead, so-called empirical approaches are followed, e.g., the practice within an industry as to transactions between unrelated parties. However, a 50/50 division of profits is often used as a starting point.

Despite this provision, in the past and perhaps to a lesser extent today abnormal pricing practices may be permitted under certain circumstances. In the case of French manufacturing companies selling to overseas subsidiaries, for example, advantageous transfer prices may be permitted if the understatement of price can be deemed a long-term investment made in the interest of the French company. This exception may be permitted for the purpose of promoting exports and to aid in the establishment of enterprises intended to sell French products abroad. The principle of arm's-length pricing also may not apply if the French company reduces its profit margins for competitive reasons and can prove it does not intend to accumulate excessive profits abroad.

It should be noted that present practice may lead not only to a reallocation of profits but also to imposition of severe penalties for illegal transfer of capital (up to 500% of the amount in question); and that the presence of these penalties may influence the settlement of disputes concerning transfers.

Where a French manufacturing company purchases components from a related company abroad, the purchase price is more carefully scrutinized. In addition, where the French company both pays a royalty for know-how from a related company and also pays a high purchase price for components on the basis of this know-how, the tax authorities may not adjust the purchase price but will disallow the royalty payment as a deduction to the French company.

In financial transactions, the authorities consider an impermissible advantage to have been granted whenever royalties are deemed excessive or loans are granted without interest between related companies. Where a French company pays royalties with respect to patents, trademarks, etc., or interest on bonds to a non-French resident these are normally deductible expenses. In the case of royalties, they must have been based on patents or know-how actually used to manufacture the product and the French company must not have been involved in the research and development process.

It is believed that, at present, many French companies are principally interested in accumulating funds outside of France for purposes of business flexibility -- so as to be able to act on business opportunities without inordinate delay caused by the necessity of obtaining government approval of investments. This situation has led some companies to enter into artificially low-priced transactions with unrelated parties in order to substantiate similarly low-priced transactions with related foreign subsidiaries.

5. Article 238A

This provision of the French tax law prevents deductions of payments to a foreign entity, whether or not that entity is related, if the recipient resides in a tax haven. A tax haven is defined as a foreign state or territory which applies a "privileged tax status." This phrase applies to any country where the company tax is two-thirds or less of what French tax would be. The tax authorities have issued a list of tax havens for purposes of Article 238A, but this list is nonexclusive. The tax authorities draw up the list on the basis of what they believe is the effective tax rate in another country, based on its statutory tax structure. Of course, countries which impose no tax on companies, or which do not tax profits from foreign sources, are automatically included on the list. Thus a number of different types of payments, including interest, royalties, management fees, etc., are nondeductible if made to an entity in a tax haven. The burden is on the taxpayer to show that the payments were actually made and that the payments were reasonable and relate to actual operations of the French company. Nondeductible amounts are added to taxable income. In addition, they are treated as dividend payments to nonresidents, and so the prepayment tax of 25% is levied as an additional tax on the disallowed deductions.

6. Article 70

Article 70 of the C.G.I. provides that a French parent company may be taxed on its foreign subsidiary's income if that subsidiary is located in a tax haven as defined in Article 238A. The French parent's share (proportional to its interest in the subsidiary) is imputed to the French parent and subject to the company tax. Losses will not be imputed. For Article 70 to apply, the French parent must own, directly or indirectly, at least 25% of the shares of the tax haven subsidiary. Attribution and constructive ownership rules are not presently described in any decrees. Credit is allowed against French tax for taxes actually paid by the subsidiary.

The provisions of Article 70 are not applicable, however, if the French parent can show that the foreign subsidiary's operations do not have, as their main effect, the localization of profits in the tax haven. This condition is deemed met if (1) the foreign subsidiary's main activity is a genuine industrial or commercial activity and (2) most of its transactions are either in the foreign country concerned or with businesses which it does not control and which are not controlled by the same third-party company.

This provision is new to the French tax code (it was enacted as part of the 1981 Finance Act), and it appears that its effect may be somewhat mitigated by several considerations. First, subsequent redistributions of the imputed profits by the French parent are not subject to the prepayment tax, as would be the case were the subsidiary located in a non-tax haven. In addition, the interest requirement of 25% leaves a "window" between 10% ownership and 25% ownership. A French parent owning an interest within that range would not be subject to Article 70 and yet would be entitled to the dividends received exemption outlined previously.

In fairness, it should also be pointed out that the degree of enforcement of the French tax and currency control rules varies according to the Government in power and perhaps also the prevailing economic conditions. Under the present Government, these rules are being enforced to an unprecedented degree. Individuals and companies found to be in violation of these provisions are sometimes criticized as having a "bad attitude" toward the laws and their country.

7. Special Tax Amnesty

Recently the French government declared an amnesty on capital abroad acquired in an "irregular" manner. Such capital would be those assets acquired abroad which were financed with undeclared income or with money illegally exported. These assets may include money, gold, securities, real property or other property. Under the provisions of the amnesty, a French taxpayer may repatriate the capital, no questions asked, upon a payment of 25% to the tax authorities. Normally these amounts would be subject to a 500% penalty. The amnesty ran from January 1, 1982, through June 1, 1982, for real property, and through March 1, 1982, for other assets.

8. Export Taxation Example

To illustrate French practices, one might consider the French exporter making sales into the Far East utilizing a Hong Kong sales subsidiary subject to a Hong Kong statutory corporate tax rate of 17%. Only a minor amount of its profit is ever subject to additional French taxation upon repatriation. Perhaps about a third of such profit might typically be retained for working capital. The balance can be repatriated to France. In France, as foreign source income, the repatriated income would not be taxed under territorial rules. Only approximately 3% of the income contributes to taxable income due to the presumed attribution of domestic expenses to the foreign dividends. Should it be necessary to then distribute this foreign source income to shareholders, the prepayment tax, which is the equivalent of the domestic corporate tax, is imposed on the corporation. However, companies generally distribute less than half of their earnings, and when doing so, French companies will distribute high-tax domestic source income rather than foreign source income. No earnings and profits "stacking" rules prevent this maneuver. Assuming that the French parent had adequate domestic source profits for distribution purposes, French taxes add negligibly to the taxes in the base country (Hong Kong), making the combined tax burden on the foreign source income no more than 18%. There are only two limitations on how much of the combined profits of the parent and the subsidiary could benefit from this low tax -- intercompany pricing rules and shareholder demand for distributions. Experience indicates French companies distribute half their profits. Thus, if a French export manufacturer and its Hong Kong subsidiary split combined profits 50/50, there would be fully-taxed profits for distribution and low-tax profits for retained earnings for the parent. To the extent that (a) shareholders wished lower distributions and (b) a larger proportion of the profits could be allocated to the subsidiary, the tax benefit for the parent would be increased.

C. Tax Treaties

France has an extensive system of bilateral tax agreements with over 56 countries.

ERRATA

1. Page 8 (last paragraph):

   The tax exemption for small enterprises applies only to newly formed enterprises, not more than 50% of the voting rights of which may be owned directly or indirectly by other companies. The exemption applies to the year in which the enterprise was created and the following 4 years.

2. Page 9 (first full paragraph):

   The rate of 17.6% should be corrected to read 18.6% in accordance with a recent increase in VAT rates.

3. Page 11, paragraph 2, "Accelerated Depreciation":

   Delete. Accelerated depreciation is no longer available on assets belonging to exporting enterprises.

4. Page 11, paragraph 3, "Export Credit Risk Reserve":

   The export credit risk reserve has been modified. The second sentence of this paragraph should read "The amount that may be reserved is 10% of the relevant credits outstanding." The last sentence of the paragraph should be deleted.

5. Page 12, paragraph 7, "Joint Export Programs".

   Delete.

FEDERAL REPUBLIC OF GERMANY (WEST GERMANY)

I. Domestic Taxation

German corporations are subject to a corporation tax, a property tax, and a Business Tax (discussed below). In general, German corporation tax is imposed on worldwide income. A rate of 56% is charged on retained profits, and a 36% rate is charged on distributed profits. The corporation tax is imposed on a company which is a resident of Germany, determined by reference to its incorporation in Germany or to the fact that the head office or management of the corporation occurs in Germany. Taxable income is generally computed on the basis of a net worth comparison of the balance sheet of the corporation for two successive years. The resulting net worth is adjusted for capital investments and withdrawals that are made during the taxable year. If the current year shows a loss, such a loss may be carried back two years up to a limit of DM 5,000,000. Any excess over this figure may be carried forward for the next five years. Property tax is imposed at a rate of 0.7% on net assets and is not deductible.

Depreciation for movable assets with a life of greater than one year is allowed on either a straight line or declining balance method. Buildings are generally depreciated on by a straight line method over 50 years. Relative freedom from inflation has had the effect of safeguarding the depreciation writeoffs from devaluation. In addition, there are special accelerated depreciation provisions for industries located in West Berlin or in certain border areas.

Taxes on the corporation itself, other than the corporate tax, are also deductible. Gains realized by a business enterprise from the sale of capital assets, including shares in a company, are normally taxable as ordinary income. However, under certain circumstances if assets sold are replaced, the gain realized on the sale of the asset is exempt.

Tax-free reserves may be established to account for price increases of raw materials and stock in trade which are fungible goods, where replacement costs have increased more than 10% within the accounting year. Such reserves may be kept for up to 6 years, and then must be returned to taxable income.

Goods and services are subject to a value added tax of 13%. There are special value added tax concessions, however, on goods manufactured in Berlin and shipped to the Federal Republic. These result in a substantially lower VAT being imposed on goods manufactured in West Berlin.

Normal tax rates are reduced by 30% for taxpayers who are resident in West Berlin with respect to income arising there, or for non-Berlin residents on income from a business in West Berlin which employs at least 25 persons.

Profits distributed by way of a dividend are subject to a 36% corporate tax rate. If the profit has been taxed in a prior year at the higher retained profits rate of 56%, the 20% excess will as a rule be credited against future taxes. Dividends distributed are, in addition, subject to a capital yields tax of 25% of the net dividend. While the capital yields tax is paid by the corporation making the distribution, it is essentially a withholding tax.

The shareholder receiving the dividend uses as taxable income a net dividend grossed up by the 36% corporation tax paid. However, the shareholder is allowed a tax credit in the amount of the corporation tax paid plus the capital yields tax. Both individual and corporate distributees are entitled to a refund of this tax credit if it is in excess of their tax liability. Under this complete integration system, no dollar of corporate income is subject to tax at both the corporate and shareholder levels. Because the 36% corporate tax on distributed dividends can be used by the distributee as a credit against his own tax liability, the effective tax on the corporation with respect to profits distributed is zero if the corporate tax is viewed as merely an advance payment of the shareholder's tax.

Under German corporate tax law, distributions are deemed to be made out of profits in the following order:

1. Retained profits (that is, profits accumulated in previous years which have been subject to the 56% corporate tax on retained profits);

2. Current profits;

3. Profits not subject to tax.

Companies whose head office and place of incorporation are in West Berlin or who employ 25 people there are eligible for a special tax rebate in respect of business income arising there. The rebate is 22 1/2% of the tax on West Berlin income, except where the income is a result of distributions from other companies in Germany. In the latter case, the rebate is only 10%.

In general, nonresidents are subject to tax on all income arising in the Federal Republic; they are, however, ineligible for a variety of the deductions normally allowed to a German resident.

The Business Tax is a tax levied by local authorities. It has two elements: a tax on the capital of the business and a tax on the profits of the business. The actual rate of tax imposed is established by local authorities. The tax rate on capital generally varies from .5% to .9%. The tax rate on profits tends to vary between 12% and 22%. The higher rates tend to be imposed by localities in highly industrialized areas.

II. Foreign Taxation

A. Export Incentives

1. A tax-free reserve may be created for profits arising from the transfer of a depreciable business asset to a company, business, or permanent establishment overseas which is engaged in industry, transport, mining, or agriculture. This transfer must be in conjunction with a new investment by the German taxpayer in the overseas company, business, or permanent establishment, or where the taxpayer already owns the overseas company or establishment. This reserve is not available if the German taxpayer has created a reserve under the special rules for investments in underdeveloped countries. This reserve must be returned to income in equal, 20% installments beginning in the fifth year after the creation of the reserve. The reserve must be returned earlier if the foreign investment or the business assets are disposed of. In the case of business assets, no early recovery is required if the disposal of the business asset is counterbalanced by a transfer of a new asset.

2. Tax-free reserves for losses incurred by a foreign subsidiary are permitted. A German company may create a tax-free reserve with respect to documented losses which are incurred by a foreign company in which the German company holds an interest of at least 50%. Only a 25% interest is necessary for an investment in a company located in an underdeveloped country. However, at least a 5% interest must have been acquired after 1968. This reserve may be maintained in the year of its creation and for the four following years, and then returned to profits. The reserve is returned to profits earlier if a profit is made; or upon disposal of the investment; or if the German company can produce no documented evidence of the loss; or under certain other circumstances.

The amount of the reserve is the share of the foreign company's losses allocable to its ownership interest in the foreign subsidiary. The upper limit for this reserve is the total value of the shares acquired by the German company as valued for tax purposes.

3. A tax-free reserve is provided for investments in underdeveloped countries. This reserve may be deducted from assessable profits, and under a recent amendment to the law the deduction is permissible even if it creates or increases an operating loss in the German business. The amount of the reserve permitted depends upon the underdeveloped country in which the investment takes place. German tax authorities have divided underdeveloped countries into two groups. Countries in the first group are poorer than countries in the second group. For countries in the first group, 100% of the investment may be placed in the tax-free reserve. For countries in the second group, 40% of the investment may be placed in the reserve. Beginning with the sixth year after the investment, there is a gradual return to income of profits of the reserve. The rate at which the return takes place also depends upon the underdeveloped country in which the investment takes place. For the countries in group one, 1/12 of the investment reserve is returned each year. For countries in group two, 1/6 of the investment reserve is returned each year. With respect to group two countries, if the investment is particularly valuable in the context of energy or raw material policy, then the reserve may equal 60% of the investment, and the reserve is returned to income at the rate of 1/12 of the investment reserve per annum.

To qualify for the special provisions for investment in underdeveloped countries, the investment must be connected with either the acquisition of shares in a company in an underdeveloped country at the time of its creation or of a substantial increase in its capital. A German taxpayer may also qualify for these special provisions if the investment is by way of loans under certain conditions or if it involves the contribution of business assets to an overseas establishment owned by the taxpayer, provided that in either case it is connected with the foundation of the business or a substantial expansion of such business. In addition, the enterprise in the underdeveloped country must be engaged in the manufacture or distribution of goods, agriculture, forestry, mining, or the provision of commercial activities other than tourism, leasing, or licensing. Indirect investments through holding companies in underdeveloped countries also qualify under certain conditions, the most important of which is that the taxpayer must own more than 25% of the holding company.

4. Goods and services destined for export are exempt from the value-added tax, and a refund to the company is available.

5. Business or trade tax. There is unilateral relief provided by German tax law with respect to the business or trade tax in the case of certain foreign source income. The following are excluded from the basis of the profit element of the business or trade tax:

a. income from foreign permanent establishments;

b. distributions from a 25%-owned foreign company, if the company is engaged in active business; and

c. profit attributable to a place of business outside Germany.

Additionally, relief is usually provided under German double taxation agreements.

6. Under the deemed distribution rule as outlined above, dividends distributed by German companies are considered to have come first, from retained profits subject to the full corporate tax of 56%; second, from current profits; and, third, from exempt profits. Thus, if a German corporation distributes dividends which total no more than its retained profits and its current domestic profits, exempt foreign source profits may be retained and used by the company without being subject to any tax whatsoever. This allocation rule has led major German companies to follow a policy of proper "income mix". Under this policy, the profit needed for distribution should be covered by fully taxed income from German sources so that exempt foreign source income can be held in the retained earnings account. As of 1980, it appeared that only one major listed German company has been forced to use exempt foreign source income for distributions. As a result of this, the value of foreign source income to a company will vary significantly depending on its income mix. A further consequence is that intercompany pricing policy has been influenced by the need to retain the correct income mix.*/. Normally, however, double taxation treaties provide for a deduction from dividends at the source. There is one notable exception, however. Dividends received by German companies from French companies are not subject to the prepayment tax of 25% normally imposed on dividends distributed by French companies to nonresidents. Because French company tax law in effect exempts foreign source income from taxation, it is useful for a Germany company to conduct foreign business by way of a French company.

---

*/ H. AULT & A. RADLER, THE GERMAN CORPORATION TAX LAW WITH 1980 AMENDMENTS 37 (2nd rev. ed. 1980).

B. Taxation of Foreign Income

Under German corporate tax law, a German company is taxed on its worldwide income. Income from a foreign branch, computed under German rules, is added to the German company's taxable income. Any foreign tax paid is credited against the proportion of total German tax payable which is attributable to the foreign source income. This, however, applies where there is no tax relief through a double taxation agreement. Foreign taxes paid, if not eligible for the tax credit, are treated as deductible expenses. International merchant shippers may, as an alternative, claim a reduced rate of tax in respect to foreign profits. This alternative, available only to shippers, allows 80% of the total foreign profits to be subject to taxation at half the average rate for the total taxable income of the company. The remaining 20% is taxed at normal rates.

Foreign source income is normally exempt from German corporate tax where a double taxation agreement exists. In addition, German tax law provides special exemptions for income derived from investments in underdeveloped countries. Because Germany has double taxation agreements with virtually all of the major industrial countries, and most of the balance of the countries in the world fall into the underdeveloped category, most foreign source income is effectively exempt from German taxation.

1. Capital gains

Where a German taxpayer sells shares in a capital company which he has held for six years and reinvests these in a foreign company, business, or permanent establishment, 80% of the capital gain may be deferred (by reducing the basis of the interest in the foreign business by this amount), if the business is in the field of industry, mining, agriculture or transport. The acquisition of the new shares must be approved by the Minister of Economics.

Unrealized foreign currency gains are not taxed on a current basis whereas unrealized foreign currency losses are currently deductible.

2. The German parent corporation can claim relief for foreign taxes paid by a foreign subsidiary on the subsidiary's profits to the extent the profits are distributed to the German parent as dividends. To qualify for this relief, the parent must own 25% of the subsidiary's stated capital. The relief is granted by way of a credit against the corporate

tax chargeable on the dividends in the following circumstances:

a. Where the dividend is from a trading subsidiary or a holding subsidiary which controls a trading subsidiary;

b. If the subsidiary is in an underdeveloped country, as long as the underdeveloped country investment relief is in force;

c. Where a trading sub-subsidiary is owned through other subsidiaries, but 25% of the sub-subsidiary must be held indirectly by the German parent.

There is a special provision for subsidiaries in the second category, that is, subsidiaries in underdeveloped countries. In this case, the amount of the credit allowed is always equal to the German corporate tax, regardless of the actual tax imposed in the underdeveloped country. It follows that dividends from underdeveloped countries are in effect exempt.

3. Generally, foreign source income is exempt under double taxation agreements. However, exempt foreign source income is included in total income for purposes of determining the tax rate on the taxable income.

Where income is exempt under a double taxation agreement, losses attributable to the foreign source income may not be used to offset German tax liability. Otherwise, losses from a permanent establishment in a foreign country may be used as an offset against German income. The loss must be a net loss from all permanent establishments in the particular country. If a loss such as this exists it is regarded in German tax law as a "special expense," which is deductible from the total taxable income of the German taxpayer. This deduction must be returned to profit in any subsequent year in which the overall income from the particular foreign country is shown to extinguish even partially the loss which was previously incurred there, unless the taxpayer can show that the foreign country involved only allows claims for losses in the year of loss.

4. International Intercompany Pricing

The statutory rule on inter-company pricing is patterned on Section 482 of the U.S. Internal Revenue Code, except that it applies only to international transactions. The law allows German tax authorities to reallocate profit on transactions between related parties, even if there has not been an overall reduction on the tax burden of the group when both German and foreign taxes are taken into account.

An arm's-length standard is required for transactions between related persons.

The intercompany pricing rules apply to all related persons. Under the law, the definition of related persons is broad. All business and personal relationships between resident taxpayers and their foreign partners come within the scope of the law and are subject to investigation regarding whether the relationship has really been at arm's-length. Double taxation treaties also provide some measures for the reallocation of profits; however, their reach is less broad than the Foreign Tax Law provisions. In an appropriate case, the tax treaty provisions on reallocation take precedence over the Foreign Tax Law provisions. As to matters not within the scope of the treaty provisions, the Foreign Tax Law is operative.

In examining transactions, German tax authorities have authorized the use of the comparable uncontrolled price method, the resale price method, and the cost plus method. Detailed regulations on this subject have been published in draft form but not yet promulgated.

The need to develop the correct income mix, as discussed above, has influenced intercompany pricing policy. For firms exporting to a foreign subsidiary, there is an incentive to show adequate profit to the German parent to cover dividend distribution needs.*/

5. Controlled Foreign Corporations

The Foreign Tax Law (Aussensteuergesetz) of September 8, 1972, is the German equivalent of the U.S. subpart F provisions. This law supplements existing provisions in German tax law concerning sham transactions, abuse of law and the like, which were not believed to be adequate for dealing with international tax avoidance.

Provisions in the Foreign Tax Law of 1972 deal with the attribution to resident shareholders of base company income derived by controlled foreign corporations, called intermediate companies. Essentially, where the requirements of the Foreign Tax Law are met income of a controlled foreign corporation is attributed directly to the German taxpayer.

---

*/ H. AULT & A. RADLER, supra note */ p. 23, at 37.

The attribution rules apply to all resident taxpayers. If the resident alone or together with other residents owns more than 50% of the issued share capital of a foreign corporation, or more than 50% of the voting rights, the attribution rules apply. Special provisions exist to prevent avoidance of the attribution through emigration by German residents to low-tax countries. There is no requirement that each resident shareholder hold a certain minimum share of the company; the 50% test is the only relevant test, and it must be satisfied each year.

This does not mean that all income of a controlled foreign corporation will be taxed in the hands of the German shareholders. Attribution applies only if the income of the foreign company represents income of an intermediate company. Income of an intermediate company is defined as all income which enjoys low taxation abroad and does not result from an activity classified in the law as active. Therefore, there are two tests which must be met before the attribution will apply; an income test and a country test.

(a) Income test

Active income is broadly defined. Agricultural and forestry income are always active, as is income from manufacturing. Income from trading is normally active; but if the trading is between the foreign company and a related person, it is considered active only if the foreign company maintains an establishment equipped for the transactions and if the foreign company is active in business life without the assistance of the controlling German shareholders or related persons. Similar conditions must be satisfied if income from services is to be classified as active income. Income from rental and leasing activities is generally considered passive, as is income from financial activities.

Dividends are normally not considered active. However, under the law dividends can be changed from passive to active income if certain requirements are met. If the controlled foreign corporation receives distributions which represent active income from a third corporation, then dividends by the controlled foreign corporation with respect to such distributions are considered active, provided that the controlled foreign corporation owns at least 25% of the distributing company's stock since the beginning of the distributing company's taxable year. In addition, the third corporation must be located in the same country as the controlled foreign corporation, or, alternatively, the controlled foreign corporation must hold the investment in the distributing corporation in connection with its own active business operations.

Where the controlled foreign corporation is in a low-tax country but has both active and passive income, this income may be viewed separately. However, if the taxpayer is able to prove that the passive income is complementary to the active operations, then this passive income is to be regarded as active income. An example of this rule would be the temporary investment of funds until the distribution of dividends.

(b) Low-Tax Country Test

In practice, a low-tax country is one which levies a tax at a rate of less than 30%. This rate is computed taking into account all taxes on income, capital gains, or net worth levied by the national government or local governments. Apparently, statutory rates rather than effective rates are treated as determinative.

The German Federal Ministry of Finance publishes lists of countries in which the rates are less than 30%, including countries granting special tax allowances.

Exemptions from the Foreign Tax Law rules are applicable to German resident corporate shareholders--

(i) on dividends from corporations resident in countries whose tax treaties with Germany provide for exemption of intercompany dividends (most German tax treaties contain an article to this effect); or

(ii) with respect to the attribution rules, where dividends which would be exempt under the corporation income tax rules are distributed by developing country corporations provided that the dividends are received directly by the resident German shareholder of the controlled foreign corporation.

6. Because the German resident shareholders must own more than 50% of the foreign corporation for it to be considered a controlled foreign corporation, a 50-50 relationship between a resident of Germany and a foreigner would not be subject to the attribution rules.

C. Tax Treaties

Germany has entered into an extensive network of bilateral tax agreements covering over 45 countries.

JAPAN

I. Domestic Taxation

Japanese companies are subject to tax under the Japanese National Corporation Tax (Corporation Tax) at two different corporate rates, depending upon whether the income subject to tax is retained or distributed. The rates are 42% on undistributed profits and 32% on distributed profits. Lower rates apply to the first 8 million yen (approximately $32,000) of taxable income of Japanese companies with capital of 100 million yen ($400,000) or less. Japanese corporations are subject to tax on their worldwide income with credit given for foreign taxes paid on an overall limitation basis similar to the U.S. system. Under internal tax law, foreign corporations having no permanent establishment or branch in Japan are taxed only on their Japanese source income from the transfer or lease of real property, the transfer of shares in a Japanese corporation (in certain cases), investment income (dividends, interest and royalties), the provision of personal services, and under certain other circumstances. Foreign corporations that do not have a fixed place of business in Japan are in most cases subject to a withholding tax at the rate of 20% on the gross amount.

In addition to the Corporation Tax, corporations with a head office, branch office, factory or other fixed place of business in Japan are subject to a Prefectural Inhabitant Tax and a Municipal Inhabitant Tax, the combined rates of which are between approximately 7.2% and 8.6% of taxable income. Such corporations are also subject to a prefectural Enterprise Tax levied at progressive rates of 6 to 12% of taxable income (6.6 - 13.2% for Tokyo and certain prefectures). This tax is deductible in computing taxable income for purposes of the Corporation Tax.

Under the Japanese "modified integration system," individual Japanese shareholders can claim a credit for 10% (in some cases 5%) of dividends received from a Japanese corporation. There is no gross up for the credit amount. Dividends received by Japanese corporate shareholders from other Japanese corporations are not recognized as income for tax purposes, except that 25% of the excess of dividends received over paid-out dividends is treated as taxable income. Dividends received by Japanese corporate shareholders from foreign corporations are fully taxable.

II. Foreign Taxation

A. Export Incentives

1. Enterprise Tax Remission

While all Japanese corporations are subject to the 12% Enterprise Tax, the portion of their profits attributable to a permanent establishment abroad is excluded from the tax base for purposes of computing the Enterprise Tax.

2. Reserves

A Japanese corporation with paid-in capital of 500 million yen ($2,000,000) or less which engages in overseas transactions may set up a "medium and small enterprise overseas market development reserve." This reserve, which is deductible from the base on which the corporate tax is levied and must be amortized over 5 years by taking 1/5 of the reserve into taxable income each year for tax purposes, has as its basic function a deferral of tax on export activities. The amount of the reserve is computed as follows:

(a) Export of Merchandise Bought from Others

(i) A corporation with paid-in capital of 100 million yen ($400,000) or less -- 1.36% of annual export sales of merchandise.

(ii) A corporation with paid-in capital of over 100 million yen ($400,000) and up to and including 500 million yen ($2,000,000) -- 0.66%.

(b) Other Exports (Exports of Merchandise Manufactured, Processed, etc.)

(i) A corporation with paid-in capital of 100 million yen ($400,000) or less -- 1.84%.

(ii) A corporation with a paid-in capital of over 100 million yen ($400,000) up to and including 500 million yen ($2,000,000) -- 0.90%.

If, for example, a corporation with paid-in capital of 100 million yen ($400,000) has yen equivalent $1 million in gross sales in year 1 and in each successive taxable year, then in year 1, $18,400 would be the amount of the deductible reserve. One-fifth of the reserve must be restored to income in each of the subsequent five years. However, given steady exports of $1 million per year, after year 5 there would be a continuous (and permanent) deferral of tax on about $55,200 of profit.

B. Taxation of Foreign Income

1. In 1978 Japan adopted certain anti-tax haven measures which operate in a manner similar to the U.S. subpart F provisions. These provisions apply to subsidiaries located in certain listed tax haven countries (about 30 countries in all).

2. Japanese exporters utilize export sales subsidiaries located in certain preferred locales. Among the preferred locales are Hong Kong, Singapore, and the U.K.

a. Hong Kong and Other "Tax Havens"

Although countries such as Hong Kong are listed as tax haven countries under the anti-tax haven measures, these measures are not applicable to a subsidiary with a head office -- which is the office so denominated in the company's Articles of Incorporation -- in a tax haven country provided:

(i) the subsidiary maintains an office, shop, factory or other fixed facility in the country of its head office;

(ii) the subsidiary actually conducts the administration, control and arrangement of its business in the country of its head office;

(iii) in the case of a wholesale business, both the sales and purchases of the subsidiary with related parties are less than 50% of the total sales and purchases respectively; and

(iv) the dividends of the specified foreign subsidiary received from other foreign subsidiaries are not more than 5% of the total revenues of the specified foreign subsidiary.

The test for whether a subsidiary in a tax haven country actually conducts the administration, control, and arrangement of its business in the tax haven, is one of substance. However, there would appear to be no problem if space were shared by two or more businesses. If two businesses shared the same employees, however, it is questionable whether the substance test would be met. Japanese tax authorities have no enforcement powers outside of Japan and foreign audits are generally based on voluntary cooperation.

b. Singapore

Singapore is not listed as a tax haven country. Singapore has an income tax treaty with Japan and does not have foreign exchange control regulations. The corporate income tax rate of Singapore is presently 40%. A taxpayer would not be considered doing business in a tax haven country with respect to a Singapore sales subsidiary even if, as is not uncommon, the Singapore sales subsidiary were not actually paying tax in Singapore by reason of a tax holiday.

Singapore itself does not tax profits of a Singapore company from overseas business if the profits are physically kept outside of Singapore. This may be accomplished by maintaining a bank account outside of Singapore.

c. United Kingdom

A non-resident U.K. company presently is not taxable in the U.K. on its income outside the U.K. A U.K. subsidiary with its center of management outside the U.K. has been used by certain Japanese companies.

3. Arm's-Length Pricing Rules

Japanese tax law contains an arm's-length pricing requirement. The arm's-length rule is generally interpreted to mean that profits must be allocated in light of each party's contribution to the realization of those profits, among other pertinent factors (such as comparable uncontrolled prices). There are no regulations interpreting the rule, and it is apparently difficult to apply in the case of a parent corporation that is publicly-held unless the pricing is clearly unreasonable.

The Japanese tax authorities infrequently challenge pricing, and there has never been a Japanese court case on the issue. Showing severe competition in a product would generally be sufficient to justify lowering prices to a purchasing subsidiary. (For reasons peculiar to Japanese society, it would be highly unusual for a pricing question not to be settled out of court.)

4. Foreign Tax Credit

By application to the Japanese tax authorities, for purposes of computing the Japanese overall foreign tax credit limitation, losses incurred by a foreign branch in one country will not reduce foreign source income in other countries.

5. Commodity Tax

The commodity tax (which corresponds to a manufacturer's excise tax under U.S. concepts) is levied at a rate of from 5% to 30% depending upon the product. Examples are: large and medium size passenger automobiles -- 30%; small size passenger automobiles -- 15%; dishwashers, ovens, mixers, etc. -- 15%.

Exports are exempt from the commodity tax. Imports are subject to the commodity tax.

C. Tax Treaties

Japan has tax treaties with 34 foreign countries including the U.S., U.K., France, Germany, Sweden, and, as previously noted, Singapore.

NETHERLANDS

I. Domestic Taxation

Dutch companies and residents are subject to tax on their worldwide income. The general rate on corporate taxable income is 48% if net profits, including foreign branch profits, are greater than 50,000 guilders. Under 50,000 guilders, the rate is 45% on the first 40,000 guilders and 60% on the next 10,000 guilders (1 guilder is approximately 0.37 dollars).

Formation expenses of a domestic corporation may be fully deducted from taxable income in the first year of operation or, alternatively, capitalized and amortized over three to five years. The primary formation expense, in addition to the normal costs, is a one-time only capital tax. This capital tax is levied at a rate of 1% of the capital contributed to the new corporation. If a Dutch company purchases the goodwill of another company, that goodwill may be capitalized and amortized over a five year period.

There are no official guidelines as to the method of depreciation. Any businesslike method is acceptable. In practice, straight line is normal, with alternative methods allowed only if it can be demonstrated that the alternative method better reflects the decrease of the asset's value.

There are special tax incentives for investment. The Act on Investment Account (WIR) of 29 June 1978 replaced prior accelerated depreciation, etc. with respect to certain areas in the Netherlands where as a matter of policy the government wishes to encourage investments. There are two types of incentives -- investment premiums and supplemental premiums. Investment premiums act as offsets against tax liabilities, and, if they exceed tax liability, become a negative income tax paid to the corporation. More than 2,000 guilders must be invested in qualified investments during the year for the premium to be allowed. The premium schedule is: new buildings -- 14%; existing buildings -- 8%; all other business assets -- 12%. These premium rates may be increased under certain circumstances. First, if investments are less than 976,904 guilders but exceed 40,706 guilders, the foregoing percentages are increased by from .25 to 6 percentage points, the higher increases being applied to the lower investment totals. Second, for designated municipalities in need of economic assistance, the above rates are increased. For investments in buildings, 20 percentage points are added; for other fixed installations, 10 percentage points are added; and for expansion of existing fixed installations, 10 percentage points are added.

In addition, for major investments totalling more than 39.8 million guilders, up to 4 extra percentage points are given. At least 10.6 million guilders must be invested in buildings or fixed installations. Also, a fixed subsidy of 33,100 guilders is given for each new employment position created by the major investment.

Neither investment premiums nor supplemental premiums reduce the basis of the assets for purposes of normal depreciation. All premiums applicable to one investment must not collectively exceed 50 percent of the investment.

Dutch tax law allows companies to set up certain tax-free reserves. These are:

1. maintenance reserves, which are formed for the purpose of spreading evenly over a number of years certain major expenditures which occur at regular (though not, apparently, yearly) intervals;

2. reserves designed to cover risks in the normal course of business that would normally be insured by a substantial number of taxpayers; and

3. where a company receives funds with respect to a capital asset which is greater than its book value, the excess may be placed in a reserve, provided that the taxpayer intends to replace the capital asset. The replacement asset must be of a similar nature and have the same economic function in the company's business. When the asset is replaced, the cost price (basis) is reduced by the amount of reserve for depreciation purposes. If the reserve is dissolved without the capital asset being replaced, the balance of the reserve must be included in taxable income at that time. Otherwise, the reserve must be returned to income after three years.

A value added tax of 18% is imposed on goods sold in the Netherlands.

II. Foreign Taxation

A. Export Incentives

1. Value Added Tax

Dutch companies can get 100% of the VAT refunded on goods and services which are exported.

B. Taxation of Foreign Income

1. Foreign Branch Income

Income received with respect to a foreign branch is includable in the corporation's taxable income. Where the foreign branch constitutes a "permanent establishment" or a "permanent agent" in the foreign country, however, the profits attributable to that branch are in fact exempt from taxation by the Netherlands. The attribution of part or all of the corporation's aggregate profits to the branch is based on the assumption that such branch is to be treated as a seperate enterprise while applying the arm's-length pricing principle. The level of profits which can be attributed to the branch will therefore primarily depend on the "substance" of the branch as compared to the substance of the corporation's total operations. Neither "permanent establishment" nor "permanent agent" is defined under Dutch law; however, it is essential that the foreign operation show a certain degree of permanence. The performance of work for a period longer than 12 months is explicitly mentioned as qualifying. Generally, an office with employees will qualify, as will a dependent agent with permanent authority to represent the Dutch company.

Foreign branch net profits are generally exempted from Dutch tax pursuant either to a treaty or unilateral measures for relief from double taxation. Under unilateral relief, the only requirement for exemption (other than the permanent establishment requirement) is that the foreign branch income be subject to foreign tax. However, it is not necessary that the tax in fact be levied or paid. If a tax holiday results in no tax, the foreign branch income could still be exempt from Dutch tax provided, however, that the tax holiday is clearly intended as a temporary measure or incentive. Should the tax holiday appear to be in fact a more permanent suspension of the income tax laws, no relief may be available and the foreign branch profits will be subject to Netherlands income taxes. The actual rate of tax imposed is irrelevant provided the tax qualifies as a true income tax. A high local turnover tax rather than an income tax could disqualify foreign branch income for the exemption/credit relief. Tax treaties may remove the requirement that the branch be subject to an income tax. This is not always the case, as the U.S. - Netherlands treaty demonstrates. Tax havens can only be attractive for foreign branch operations if the tax haven levies some kind of income tax on the branch income and if the branch has sufficient substance. Without substance no substantial income could be attributable to the branch.

Net losses from foreign branch income may be deducted from domestic taxable income, thus reducing the tax liability of the Dutch company. However, this net loss must be recaptured by reducing the exemption for foreign branch profits in one or more of the subsequent eight years.

If domestic operations produce a net loss while foreign operations produce a net profit for the corporation, the worldwide profit -- net foreign and domestic profit -- will be less than foreign profit. In such a situation the excess foreign profit (more than necessary to reduce, through exemption, the corporate taxable income to zero) may be carried forward for eight years and acts so as to increase the exemption with respect to foreign profits in those years.

Preferred locations of foreign sales branches are Cyprus for Middle East sales, the Netherlands Antilles for the Americas, and Switzerland for Europe.

2. Foreign Subsidiary Income

There is no direct taxation on the income of a foreign subsidiary of a Dutch company. Both dividends received and capital gains arising from a foreign corporation in which a Dutch company has an interest are generally exempt from Dutch taxation. To qualify for this exemption, the Dutch company's interest in the foreign corporation must meet several tests:

(a) the Dutch company must have at least a 5% equity interest in the foreign corporation;

(b) this interest must be held continuously from the beginning of the taxable year;

(c) the subsidiary company must be subject to foreign income tax (but the rate is irrelevant and withholding at source is not required);and

(d) the shareholding must not constitute passive portfolio investment.

Some controversy has surrounded the last requirement. The Dutch Supreme Court ruled in 1973 that a Dutch holding company, owning 100% of several foreign subsidiaries, was not eligible for the dividends exemption because the holding company did not, by definition, have any business activities. This led to considerable discussion which resulted in a Dutch Tax Administration ruling that "active coordination" of foreign subsidiaries was enough to remove such holding companies from the "passive portfolio investment" category. This ruling permits the taxing authorities to grant the exemption where the subsidiaries are active operating companies and where the shares of the Dutch holding company are in turn owned by an active company of substance since, in this case, there is a direct management line between the parent of the Dutch company and its subsidiaries. Therefore, by its nature the Dutch holding company cannot own subsidiaries as portfolio investments, but rather acts as a conduit to an overseas parent and is considered as "coordinating" foreign subsidiary income.

Tax treaties usually provide the Dutch parent with a tax credit for withholding taxes on interest, dividends, or royalties paid to a foreign state. Where there is no treaty with the foreign state, foreign taxes paid (where other exemptions do not apply) are deductible expenses to the Dutch parent. Additionally, tax credits are allowed on withholding taxes paid with respect to interest and royalties by a resident of certain lesser developed countries (LDCs). Currently, approximately 80 LDCs qualify for this credit. The tax must actually be paid in this case.

3. Intercompany Pricing Rules

Under Netherlands tax law, the authorities can adjust the prices of intercompany transactions if it is established that these are not at arm's-length. Arm's-length pricing implies that the manufacturer receives its cost plus profit mark-up for its manufacturing activities. On the other hand, the profit of the sales subsidiary should also reflect an arm's-length result taking due notice of its activities and function. As a practical matter, tax authorities will not find arm's-length pricing to exist where the parent company shows a loss on the transaction and the foreign sales subsidiary shows a profit on subsequent resale unless the arm's-length character of this transaction can be demonstrated beyond a doubt by the taxpayer. Such a demonstration is usually impossible.

There are no fixed rules in the Netherlands for profit allocation. The existence of an arm's-length transaction is determined on a case-by-case basis depending on the facts and circumstances; there are no safe-haven rules. Companies can negotiate this point with the Dutch taxing authorities prior to the transaction, and reach an agreement which is good for a considerable period of time -- over several years. Rulings such as this are binding on the Dutch tax authorities.

A transfer of profits already certain or a profit potential by a Dutch company to a foreign sales subsidiary could be construed by the tax authorities as a transfer of goodwill. Once this profit is realized, its value would be taxable to the transferor at normal rates (capital gains are not taxed at special rates).

The use of foreign sales subsidiaries is discouraged to some degree by the fact that the Netherlands Credit Company, a Dutch government institution, will not insure credits extended to foreign related parties with respect to exports.

C. Tax Treaties

The Netherlands has entered into an extensive network of bilateral tax agreements with over 35 countries.

SWEDEN

I. Domestic Taxation

Swedish corporations are subject to tax on income from whatever source. The decisive factor for determining residence is the nationality of the corporation, not its place of management. Thus, corporations formed abroad which are managed from Sweden are generally not subject to Swedish taxation.

Swedish corporations are liable for two taxes on income, the National Tax and a municipal or local tax. The rules for computing net income are essentially the same for both. The National Tax is levied at a flat rate of 40% on net income. The local tax is also applied at a flat rate, but this rate is set by local authorities. On average the local tax rate is about 29%, but there is a variation among localities of about 7 percentage points.

In computing taxable income, Swedish corporations are allowed deductions for current expenses. Deductions are allowed for municipal taxes imposed either directly or indirectly on the Swedish corporation. Foreign income taxes imposed may be either credited against Swedish taxes or taken as a deduction; foreign excise taxes are deductible. In addition, there are special provisions governing depreciation, capital gains, and special reserves. Net losses may be carried forward for a period of 10 years.

When an asset is sold, unused depreciation may be written off to the extent it exceeds the proceeds from the sale, while proceeds in excess of the remaining depreciation become taxable profits.

There are two methods of depreciation available -- the book method and a variation on the book method called the remaining balance method. The book method generally allows for depreciation of assets other than buildings at the rate of 30% annually.

There is no separate tax on capital gains. Capital gains when taxable are included in ordinary income. Assets are divided into three main categories: real property, shares and other similar securities, and movable property excluding shares. Inflationary appreciation in the value of real property is not subject to tax. Capital gains from the sale of movable property other than shares receive very favorable tax treatment with no tax liability at all if the property is held for more than 5 years.

Capital gains from the sale of shares are taxable regardless of how long the shares have been held. If the shares sold have been held for a period of less than two years, 100% of the gain is taxable as ordinary income. If the shares have been held for two years or more, only 40% of the gain is treated as ordinary taxable income. Capital losses on the sales of shares may be fully deducted if the shares have been held for less than two years, while 40% of the loss may be deducted for shares held two years or longer. Capital losses are only deductible against capital gains; net capital losses may not be set against net operating income for the purpose of computing taxable income.

There are three principal types of tax-free reserves permissible under Swedish tax law. The first is a reserve with respect to inventories. The second is a profit equalization reserve. The third is a general investment reserve.

The tax-free reserve with respect to inventories is essentially a form of depreciation on the value of inventory acquired each year. The profit equalization reserve allows companies engaged in business or agriculture to allocate up to 20% of their total annual payroll to a tax-free reserve. This reserve is returned to income in the following taxable year; however, because this reserve can be set aside each year, it in effect acts as a permanent deferral.

Swedish companies may allocate up to 50% of their annual profit, before taxes, to a general investment reserve, which is deductible for national and local income tax purposes. Half of this reserve allocation, however, must be paid into a special investment account at the Swedish National Bank. If the government requires, or if the company requests and the government approves, the investment reserve may be used for certain domestic purposes or for development of an export market. After five years, the company is entitled to reclaim 30% of the deposit made in the Swedish National Bank without the need to seek special permission. This amount may be used for most, but not all, of the permitted purposes.

A value added tax is levied at a nominal rate of 17.7% on approximately 70% of the goods and services consumed within the country. This nominal rate corresponds to a rate of 21.51% on the price excluding the value added tax itself from the base. There is a reduction of the value added tax on some goods and services.

There is no general provision in Swedish tax law which relieves profits made by a corporation from taxation at both the corporate and the shareholder levels. In the case of dividends received by a Swedish parent corporation from another Swedish company in which the parent owns at least 25% of the voting power, dividends are exempt from taxation to the Swedish parent. Swedish companies which are classified as holding companies or investment companies are not eligible for this exemption. In the case of holding companies, tax liability exists on dividends received to the extent that the amount of such dividends does not correspond to dividends paid to the holding company's own shareholders in the same income year. Investment companies are allowed exemption from tax on dividends received if their own dividends paid out for the same income year correspond to 80% of the dividends received.

As of 1983, a company which is not quoted on the stock exchange will, under certain conditions, be entitled to a deduction in respect of distributions made during a fiscal year. This deduction will be limited to companies which are carrying on business, agriculture or forestry. A holding company will not be entitled to this deduction. The deductible amount will be limited to 70 % of the distribution. However, the deductible amount may not exceed 15 % of the share capital or SKr 700,000 (approximately $115,000) per year. A deduction will not be allowed if the recipient is exempt from tax on the distribution received. This means that the deduction will not be given to the extent that the distributing company is owned by a company which in its turn is not taxable in respect of the dividends received. This feature obtains if the recipient holds 25 % or more of the shares of the distributing affiliate.

A second special deduction is allowed in certain cases to companies with respect to dividends distributed. A distributing company may deduct from its profits the amount of the dividend distributed to its shareholders up to a total of 10% of the paid-in capital of the corporation in a single year. This deduction may be taken annually over a period of twenty years; however, it is limited to a total of 100% of the qualifying paid-up capital. Swedish holding companies which own shares representing in excess of 50% of the voting stock of the distributing company do not qualify for this special deduction. The deduction is not available for a Swedish parent company owning in excess of 25% of the voting stock of the distributing company; nor is it available where Sweden must reduce the withholding tax on outgoing dividends to zero under a tax treaty with the country of the recipient. This deduction reduces the amount of the deduction which may be taken by a company under the provisions outlined in the previous paragraph.

Nonresidents are taxed on Swedish source income derived from business, royalties or real estate situated in Sweden and any gains from the disposition of business assets or real estate in Sweden. The taxable income of a Swedish branch of a foreign corporation is computed as if the branch were a resident corporate entity. Foreign corporations that establish a Swedish office that functions as a management headquarters are not taxed if the office does not generate a profit and does not engage in selling activities. Nonresident companies are subject to the National Capital Tax on net assets located in Sweden at the end of each year. This tax is almost always waived under Swedish tax treaties. Interest paid to individuals or corporations abroad is not taxable in Sweden. Dividends paid to nonresidents are no longer treated as taxable income. A withholding tax of 30% is levied instead. Withholding rates for nonresidents living in countries with which Sweden has a double taxation agreement are generally significantly lower than 30%.

II. Foreign Taxation

A. Export Incentives

1. The Investment Reserve

As indicated above, a Swedish company may create a tax-free investment reserve which may subsequently be used for certain government approved purposes. One of these purposes is for the development of export markets.

2. Value Added Tax

There is no value added tax imposed on goods destined for export. In addition, export transactions are not subject to excise taxes.

3. Export Credit Support

The Swedish government may grant a special allowance against taxable income under the following circumstances.

(i) The export is of significant importance to the Swedish economy and the current employment situation, and there is reason to assume that the applicant's foreign competitors have access to export credit support in their home countries.

(ii) The export consists of capital goods or consulting services to be used in the country in which the buyer is domiciled or, in the case of a subcontract, to be used in the country to which the goods are sold by the main contractor.

(iii) More than half of the agreed-upon purchase price and not less than SKr 300,000 (approximately $49,000) is covered by an export credit.

(iv) The credit runs for a period of at least 2 years.

(v) At least half the amount needed to finance the credit is borrowed in a bank or credit institution. The maximum allowance is 4% of the outstanding export credit claims at the beginning of the financial year. To obtain this special allowance, a Swedish company must apply to the Swedish tax authorities before the end of the taxable year in which the export credit agreement is concluded. The allowance may not generate a loss on the total taxable income of the business. If because of this provision the company cannot obtain the full benefit of the special deduction allowance, the company may apply for a grant of up to a maximum of 50% of the calculated allowance. The grant is not taxable income.

B. Taxation of Foreign Income

1. A Swedish company is taxable on its worldwide income regardless of source. Both the national and local taxes have to be paid on worldwide income.

2. There is no Swedish equivalent of U.S. subpart F provisions. However, there is a provision which allows Swedish tax authorities to "look through" a corporation's foreign site of incorporation. If the corporation is formed abroad with the obvious purpose of evading Swedish taxes, but is owned by Swedish citizens, the tax authorities may tax it as a Swedish economical association although it is not in fact a Swedish corporation. Application of this provision is infrequent. Profits of foreign subsidiaries are taxed only when distributed to the parent company.

3. Unless a tax treaty provides otherwise, dividends from foreign subsidiaries are not eligible for the dividends received exemption. However, a Swedish company may be granted a dividends received exemption for dividends from a foreign subsidiary by special decision of the National Tax Board.

4. Relief from double taxation on foreign source income of Swedish companies is normally provided by double taxation agreements. There are, however, certain unilateral provisions in Swedish tax law which at least mitigate double taxation where there is no bilateral agreement in force. Sweden grants partial relief from double taxation of foreign source income by allowing foreign taxes to be deducted as an expense in computing taxable income. To the extent this deduction does not eliminate double taxation, a foreign tax credit is also allowed. The foreign tax credit is creditable only against the national income tax; it cannot exceed

the Swedish tax attributable to the foreign income. There is no such credit available with respect to the local tax. These unilateral relief provisions are currently being considered for amendment.

Generally, a foreign branch is regarded as a dependent part of the Swedish company. Losses of such a branch may be deducted from domestic earnings even where Sweden has entered into a tax treaty under which Sweden may not tax the income of the foreign branch.

5. Foreign Tax Credit

If a taxpayer chooses to deduct, rather than credit, foreign taxes paid, the deduction is used in the calculation of both the national and the municipal tax bases. The credit, however, may only be used against the National Tax. Often a deduction is taken for estimated foreign taxes but, when settled, the Swedish company will refile and claim a credit, instead, if that is more beneficial.

6. Intercompany Pricing Rules

Where a Swedish corporation and a foreign corporation are related or members of the same group, Swedish tax law requires arm's-length pricing. There are no detailed regulations in Sweden regarding the application of this rule. Where Swedish tax authorities find that the dealings between the Swedish company and the foreign company have not been based on arm's-length principles, they may reallocate the income.

Interest paid by a Swedish corporation to a nonresident parent corporation is generally deductible to the Swedish subsidiary. However, a deduction may be denied for excessive or unreasonable payments which are then treated as a concealed dividend paid by the Swedish subsidiary to the foreign parent corporation. Interest paid to a foreign resident by a Swedish resident is not subject to withholding in Sweden; this is in line with the general exemption from Swedish tax of interest received.

C. Tax Treaties

Double taxation agreements usually provide for a tax-free distribution of dividends from a foreign subsidiary to a Swedish parent under the same conditions as those imposed for qualification for the dividends received exemption on dividends received from a Swedish subsidiary by a Swedish parent.

Double taxation agreements avoid double taxation by one of two methods -- exemption of income or ordinary tax credit. Under the exemption approach, the double taxation agreement allocates items of income to taxation by one of the two countries and exempts them from tax in the other. Where the ordinary tax credit method is used, both Sweden and the other country may tax the income, but Sweden must reduce its tax on Swedish residents by an amount corresponding to its own tax or the tax of the country of source, whichever is the lower. The exemption method was the principal method used in double taxation agreements entered into before 1965. Since then, the ordinary tax credit method has dominated in Sweden's tax treaties. As noted above, the losses but not the gains of a branch of a Swedish company located in a treaty country with a tax exemption type treaty may be taken by the Swedish company.

UNITED KINGDOM

I. Domestic Taxation

A corporation with its place of management in the U.K is subject to U.K. corporate tax on its worldwide income. Place of management is determined on the basis of all the relevant facts and circumstances. Important factors include where the members of the Board of Directors hold their meetings and the place of residence of the directors.

The U.K. corporate tax rate is 40-52%. Nonresident corporations are liable for U.K. tax only on income from a trade within the U.K. Also, nonresident corporations are subject to tax on certain U.K. source income under a withholding system similar to the U.S. system. U.K. resident corporations may credit foreign income tax paid against U.K. corporate tax on foreign source income under a system similar to the U.S. system but with a "per country" rather than an "overall" limitation.

Individual U.K. shareholders of a U.K. company must gross up dividends paid to them by a fraction (changed annually, but approximately 3/7ths) of the distributed amount. They may then take a credit against their U.K. taxes in the amount of the gross-up. This partially alleviates the full taxation of corporate profits at both the corporate and shareholder levels.

The U.K. tax system provides for an advance payment of the corporate ("mainstream") tax through the mechanism of Advance Corporation Tax ("ACT"). A U.K. corporation making a distribution to a U.K. shareholder must make quarterly payments of ACT, in an amount equal to the fraction described above, of distributions made during the quarter, but it may offset this amount against its mainstream corporate tax liability at year-end. Although no refund of ACT is permitted if mainstream liability at year-end is less than ACT paid during the year, the excess ACT may be carried forward indefinitely or transferred to an affiliated corporation during the same income tax year.

Especially noteworthy features of U.K. corporate tax include its system of depreciation and stock relief provision. A U.K. corporation may elect to take 100% depreciation in the first year of acquisition for machinery and plant (79% for the construction of industrial buildings). This election is restricted to U.K. resident corporations, but applies to their worldwide assets. Under the U.K. stock relief provision, payment is forgiven on the portion of the corporate tax which is considered attributable to inflationary price increases in inventory.

A liberal form of consolidation is allowed U.K. companies through provisions known as "group relief."

II. Foreign Taxation

A. Export Incentives

1. A border tax adjustment is provided in the form of a refund of the value added tax (generally 15%) on all exported items.

2. A deduction is permitted for business entertainment expenses of customers resident overseas. No similar deduction is provided for expenses of entertaining domestic customers.

3. In 1977, legislation was enacted permitting anyone who works overseas for at least 30 days in any tax year to claim a tax deduction of 25% of their overseas earnings. Section 31, Finance Act 1970. The days spent working abroad do not have to be consecutive, as long as they total more than 30 days. Normally the salary to which the 25% deduction applies is calculated on a time-apportionment basis (days overseas divided by 365). Where an executive has a separate contract for an overseas employer which is not an affiliate of the UK employer, the 25% deduction applies to the actual salary earned overseas. If 365 days or more spanning two tax years are spent working abroad then none of the employee's overseas earnings are taxable in the U.K.

B. Taxation of Foreign Income

1. The U.K. does not have an equivalent of the U.S. subpart F provisions. The issue of whether to impose a variation of subpart F was recently raised in a "consultative" document issued by the U.K. Treasury in January 1981. In November 1981, however, these proposals were withdrawn from parliamentary consideration. There is thus nothing in U.K. law to prevent the accumulation of foreign source earnings of subsidiaries of U.K. corporations in low tax jurisdictions (other than with respect to personal holding companies, whose accumulation of profits is limited by section 478 of Taxes Act 1970).

2. Section 482 of the Taxes Act 1970

The prohibition against creating foreign sales subsidiaries, which formerly existed under the U.K. foreign exchange control laws, was ended in 1979. The only other measure in U.K. law which might bar establishing a foreign sales subsidiary in a tax haven jurisdiction is section 482 of Taxes Act 1970.

This section prohibits "migration" of an existing trade of a U.K. corporation. It is apparently a small hurdle for any international concern with access to expert advice. Appropriately drafted applications for an exception to section 482 are usually accepted, especially since the abolition of exchange controls. An exception is necessary only in the case of an existing U.K. corporation that wishes to move a part of its trade outside the U.K. No approval is needed to create a new company overseas to conduct sales if this is a new activity. Accordingly, a U.K. manufacturer which has previously sold to overseas distributors but who wishes to incorporate its own overseas distribution subsidiary would be exempt from section 482 because it is not transferring the trade of distribution out of the U.K. An overseas sales subsidiary should have some corporate substance to avoid the argument that its seat of management is in the U.K.

Applications for sales subsidiaries in a Crown Colony, such as Hong Kong, appear to be routinely approved.

While criminal penalties exist for enforcing section 482 -- against both the company and its professional advisors -- no prosecutions have ever been brought under this section.

3. Transfer Pricing

There is no special provision of law for dealing with international sales at an understated or overstated value. Section 485 of Taxes Act 1970 provides a rule, similar to U.S. section 482, requiring arm's-length dealing between controlled entities. To date, there have been no decided cases under section 485.

Factors which a U.K. company may show in order to justify low transfer prices include commercial factors such as market penetration difficulties and competition. Experience has shown that a U.K. company may also show that the activities of a foreign sales subsidiary will increase U.K. exports. Such assertions are known to have considerable influence on the attitudes of the authorities towards low prices for export to selected companies.

A specialist team to insure compliance with an arm's-length standard has recently been created by the Inland Revenue and charged with reviewing all transactions between U.K. companies and overseas companies. However, the size of the unit is only fifty individuals.

4. Foreign Tax Credit

While the U.K. operates on a per country limitation for foreign tax credit purposes, an overall limitation may effectively be obtained by the interposition of a holding company between the overseas subsidiaries and the U.K. parent. A Dutch holding company is commonly used for this purpose. Excess foreign tax credits may not be carried over.

An indirect foreign tax credit may be claimed provided the U.K. parent owns at least 10 percent of the voting power of the subsidiary paying dividends. Unlike the U.S., the ownership requirement is examined at each level. Thus, if a U.K. resident company owns 10 percent of a foreign company which in turn owns 10 percent of a second foreign company, the U.K. resident will receive a credit for its proportionate share of the taxes paid by both foreign companies.

A U.K. corporation may choose to deduct, rather than credit, foreign taxes paid.

5. Favored Locations

Favored locales for establishing overseas sales subsidiaries include: Bermuda, the Bahamas and the Netherlands Antilles for distribution operations to Central, North and South America; Cyprus for sales operations in the Middle East; Hong Kong, often in conjunction with overseas manufacturing subsidiaries in Singapore, for Far East sales and distribution; and the Channel Islands for European sales or international marketing generally.

C. Tax Treaty Rules

Several countries have secured the inclusion in their double-tax treaties with the U.K. of a "tax sparing" article preserving foreign tax credit benefits to the U.K. corporate investor even if the tax for which credit is sought is not paid due to a tax holiday or other tax relief measure in the other contracting state.

APPENDIX

Telex to Correspondent Counsel

To: Correspondent Counsel

Re: Export Practices

1. We represent U.S. exporters interested in surveying actual export practices followed in ________________.

2. While some information is available from treatises and other secondary sources, we must obtain current information and information which reflects actual experience. If a statutory provision calls for one result and another result is actually achieved by exporters (by government concession, for example), we must focus on the latter.

3. I will telephone you on ___________________________, unless you telex a more convenient date, to discuss this matter. If it is decided at that time that you will undertake this project, I will ask that you research the questions, call me if there are any questions arising as a result of that research, telex me the answers, and be available for additional questions.

4.1. Assume that M is a manufacturer resident and taxable in _______________. M desires to export items of manufacture from ________________ to Country Y. It wishes to utilize a foreign sales subsidiary and to allocate as much taxable income as possible to that subsidiary in order to minimize its domestic taxes. (If a particular foreign locale or locales are favored as a base for such subsidiary, assume that the subsidiary is located in such a locale. Please identify such locale(s) and identify why such locale(s) are favored. If another approach to minimizing home country taxes is preferable, please identify this approach.)

4.2.1. When computing combined parent and subsidiary export profits, what deductions, reductions, offsets, etc., are allocated against export transactions? Specifically, are interest, head office expense, general and administrative expense, research and development, plant, overhead, depreciation, or other fixed manufacturing costs, pension, generally allocated to export sales? Note that to the extent that any allocable expense is ignored in the combined export profit calculation, calculated profit is increased, and there is the possibility that some of this profit increase might be attributed to the foreign sales subsidiary.

4.2.2. On solidly profitable export business (i.e., business with pre-tax margins of greater than 4 percent of gross export receipts), what is the allowable split on profits between M and the subsidiary (for example, 50:50; 75:25)? Is any basis other than percentage split utilized (e.g., dollars per dollar gross export receipts or setting prices from the parent to the foreign sales subsidiary at some minimum markup over defined costs)?

4.2.3. On marginally profitable export business (i.e., business with pre-tax margins of 4 percent or less) or on so-called loss business (where customer prices do not cover direct costs plus full absorption of allocable expenses), how many dollars per dollar gross export receipts are allowed to accrue to the subsidiary? What procedures insulate the subsidiary from possible losses on individual export transactions?

Mr. **NOWAK**. Once again, we will digest all of this. If you do have any further thoughts after listening to what happened today, and if you could spend some time thinking about how this could generate down to the small business community, we would appreciate your letting us know, because I think we are going to have a very real opportunity to go before the Ways and Means Committee with this to give them the benefit of all of these hearings. I hope that they don't just very narrowly look at this issue from a lost revenue point of view. If they do that, I think we are going to miss an opportunity here to put a package together that could really be a help out there.

Due to the complexity and everything that has been mentioned here, it is very understandable why we don't have small DISC's out there and more of them performing today. When you look at the figures, 90 percent are done by a very few small firms here which are getting a small advantage. I suppose if I had the opportunity to export and somebody laid all of this on me, I would have second thoughts about getting involved in it. But maybe we can make it simpler and make it broader without the budgetary impact that everybody is worried about. If we can do that, I think we will have really made some headway.

Mr. **McDONOUGH**. One comment I would like to make is that, for 6 to 8 years, we have been talking to the Commerce Department, and we have been saying, "Why isn't there a Small Business Export Council." The President's Export Council is made up of the multisize companies. Their answer to us is they will put a small businessman on the President's Export Council and he can represent small business. Well, he is going to have about as much of a chance there as a snowflake in the middle of July.

I think small business needs its own President's Export Council. To sum that up, we go to the Commerce and, in many instances, many sections of the Department of Commerce don't know small business exists. That is not meant to be unkind, that is a fact of life of dealing with them. So our next alternative is to go the SBA, and frankly, in most cases, the SBA doesn't know much about exporting or to give us any guidance in exporting.

So we are sort of caught in a "never, never land" where no one is listening to our problems. When DISC was put together, I don't think any small business people were asked how we would like this, or what can it do for you and how can we design it. Maybe it is time we need some sort of an advisory council of small business people that would put together some export programs for small business and have input to it.

Mr. **NOWAK**. Hopefully, we can draw together a large consensus here, and not only have an impact on the SBA, but more so probably in Commerce, which is going to have a greater input into this thing. If we could just put a program together that is reachable, perhaps by some corresponding State agency. I know many States, I think there are some 14, that have some kind of an export expert within the State government. If they could be coordinated and developed throughout the 50 States in a nice tight network, I think we could see just tremendous results in the future of small business gaining access to this huge market that is out there.

Again, thank you very much for appearing. We are going to leave the record open. If we have further information, we will get back to you. Thank you again for your attendance.

[Mr. Marriott submitted the following statement from a constituent to be inserted in the hearing record:]

Prepared Statement of Gerald J. Lupo, President, G. J. Lupo Co., Inc., Salt Lake City, Utah

Mr. Chairman, Members of the Committee, I am the President of the G. J. Lupo Company, Inc. of Salt Lake City, Utah. My company has manufactured products used in the Rotary Drilling Industry for almost 13 years. These products consist of drill stems, stabilizers and drill bits.

Export sales represent approximately 35 percent of our total annual sales. The many countries to which our products are exported include South Africa, Zambia, Zaire, Liberia, Senegal, India, Greece, Peru, Argentina, Russia, Mexico, the Philippines, and Canada. Our products are basically used wherever rotary drilling is employed for water wells and/or mineral exploration (including such base metals as copper, gold, silver, and iron ore).

In order to broaden our sales base I have emphasized the export market. It is my experience that when our domestic sales are down, our foreign sales are up. I believe a principle reason for this is that foreign purchases are generally much larger, sometimes a year's supply; and, extended lead times are required. As our export sales increased, we found it progressively more difficult to finance such sales because of the need for immediate additional working capital. Since domestic sales are generally made in smaller lots, the case flows are steadier.

I have not experienced any serious problems in customer payment on export sales once the product was shipped, since we generally use an irrevocable Letter of Credit, a Bankers' Acceptance or a Sight Draft, depending upon the particular customer and our past business experiences. Payment generally occurs in 30–45 days; and, some banks will discount either a credit letter or the bankers acceptance. These actions solve the cash flow problem.

This is not the principal problem which a small business has in export sales, however. The first problem a small business has is obtaining orders. Once an order has been obtained, the second and more serious problem arises: procurement of working capital. This problem is the topic of this testimony.

About a year ago, we started working with a trading company which conducts extensive business with Russia. A larger order was placed with a major American rotary drill manufacturer (such drills to be used in a large open cast coal mine in Siberia). The consumables, such as the products we manufacture, were to be placed separately. The first order for drill stems (totaling $1.2 million) was placed with our competitor in Texas, a firm approximately 5 times larger than our own. They are a wholly owned subsidiary of a firm listed on the New York exchange and having annual sales in excess of $1 billion. We obtained both the second and third orders for stabilizers (for approximately $250,000) and for drill stems (totaling $1.3 million). All orders were to be backed initially by an irrevocable Letter of Credit. For various credit reasons, the trading company could not obtain an acceptable Letter of Credit. However, a security agreement was drafted that bypassed the trading company, and this agreement was backed by the Russian Government.

During the initial negotiations, special extended payment terms were requested. According to this agreement, the final payment of $350,000 would not be made for 120 days after the final shipment; interest was added to the base price in order to cover these terms. When first proposed on these extended terms, the agreement was unacceptable to my company and we offered instead a discount for prompt payment. However, our competitor agreed to their terms, since their available finances are far greater than our own. Consequently, we had to agree to the extended terms as well. Our plant had the capacity, and an order of this size would have created additional jobs for about 30 people. While we obtained the contract, this still left us (as a small business) with the need for additional working capital (in this case, approximately $750,000).

We took several steps to obtain the necessary working capital. One of these was to approach the Utah Industrial Development Council believing that they might have special funds available for such development. They directed us to the Eximbank and the Commerce Department. However, Eximbank does not finance Eastern Bloc Countries and the U.S. Department of Commerce ITA merely suggested approaching local banks.

As we had a revolving line of credit with a finance company, we also contacted them to discuss the possibilities. They suggested that once we turned this order into a receivable, they might fund against this. Local banks also were not interested in funding working capital, but were interested in funding against the receivable. The principal questions about financing were: "What if you don't produce or cannot produce?" and "What collateral do you have?" Since my company held an SBA loan and a line of credit, our collateral was unfortunately pledged.

Finally, it was suggested that our balance sheet was not strong enough to take on an order this large. At this point we contacted the local SBA office and were told that they could not help us; they instead suggested that we work with the bank with which we had our existing SBA loan. Again, this bank was not interested. In frustration, I contacted Congressman Marriott's office and spoke with Rick Centner who is on the Small Business Committee staff. During our conversation, I was told that there was an SBA Export program that might be applicable to our situation. The regional SBA office in Denver was not familiar with the program. They thought the L. A. office of the SBA could be of more assistance. The L. A. office was indeed more informative, as they have been previously involved in an SBA export program. However, this was only a pilot program and was tried in several large cities. Further, the program had been withdrawn and sent back to committee for modifications. The Denver office informed us of this, but said that we might qualify under the Contractors Program, suggesting that we again contact our local SBA office. Unfortunately, the local office was not familiar with this program either, since it had only been used once by their office. Again, no one was quite sure if we were qualified under this program.

We did submit an application to one of our local banks. However, by this time, the Russian order was withdrawn and given to our competitor, as we were unable to guarantee our financial performance. Four to six weeks required to research the relevant SBA Programs was unwarranted. It seems to me that, as part of a government agency supposedly serving small businesses such as mine, the regional and local offices should be better informed.

In private industry, new products are announced and people informed through news letters or other information services. To this date, I am still not sure if we qualified for the Contractors Program of the SBA. I do not really feel there is anyone in the SBA who can give any indepth information on their Pilot Export Program.

If small businesses are going to compete in the export market, there must be some form of export financing programs. Not only in the form of receivable financing (as with the programs offered by the Eximbank or Foreign Credit Insurance Association), but also in the form of working capital or direct loans.

One system used by the Japanese involves large trading companies representing many smaller companies. One example of such a program involves the Mitsui Company, from which we purchased Japanese steel through a small specialty steel mill called Diado Steel. When an order was placed with Mitsui, Mitsui then placed the order with Diado. Diado was paid immediately in the form of a Letter of Credit from Mitsui. However, Mitsui was not paid until 30 days after we received our steel. This is one example of how the Japanese finance a smaller business firm beyond receivable financing. I suggest we take a serious look at this, and at other programs which are enabling our foreign competitors to so completely outstrip American small businesses in export markets.

I suspect that my Company's experience is far from an isolated one. I hope this Subcommittee will continue its efforts to find approaches to exporting that will make catch-22 situations such as ours a thing of the past.

Mr. NOWAK. The subcommittee is adjourned.

[Whereupon, at 3:44 p.m., the subcommittee adjourned, to reconvene subject to call of the Chair.]

○